

**Charles University**  
**Faculty of Social Sciences**  
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**MASTER THESIS**

**Estimating the Determinants of FDI in Transition Economies**  
**Comparative Analysis of the Republic of Kosovo**

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## **Declaration of Authorship**

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## ***Abstract***

This study develops a panel data analysis over 27 transition and post transition economies for the period 2003-2010. Its intent is to investigate empirically the true effect of seven variables into foreign flows and takes later on the advantage of observed findings to conduct a comparative analysis between Kosovo and regional countries such: Albania, Bosnia and Herzegovina, Macedonia, Montenegro and Serbia.

As the breakdown period (2008-2010) was included in the data set used to modelling the behaviour of FDI, both Chow test and the time dummies technique suggest the presence of structural break. Ultimately, empirical results show that FDI is positively related with one year lagged effect of real GDP growth, trade openness, labour force, low level of wages proxied by remittances, real interest rate and the low level of corruption. Besides, the corporate income tax is found to be significant and inversely related with foreign flows.

The comparative analysis referring the growth rate of real GDP shows that Kosovo has the most stable macroeconomic environment in the region, but still it is continuously confronted by the high deficit of trade balance and high rate of unemployment. Appart, the key obstacle that has abolished efforts for foreign investment attraction is found to be the trade blockade of Kosovar products by Serbia and Bosnia and Herzegovina together with the unenviable position of Kosovo regarding the doing business climate and the failure to reduce the level of corruption.

### **Keywords:**

Foreign Direct Investment, Republic of Kosovo, Structural Break, Transition Economies, Groupwise Weighted Least Squares

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## **Acronyms**

ACA – Anti Corruption Agency

AKB – Alliance of Kosovar Business

ATP – Autonomous Trade Preference

BIT – Bilateral Investment Treaties

CBK – Central Bank of Kosovo

CEE – Central and Eastern Europe

CEFTA – Central European Free Trade Agreement

CIS – Commonwealth Independent States

CSEE – Central and South Eastern Europe

ECIKS – Economic Initiative for Kosovo

EMC – Emerging Market Countries

EU – European Union

FDI – Foreign Direct Investment

GDP – Gross Domestic Product

ICOR – Incremental Capital Output Ratio

IMF – International Monetary Fund

IPA – Investment Promotion Agency

IPAK – Investment Promotion Agency of Kosovo

KAS – Kosovo Agency of Statistics

LDC – Least Developed Countries

MNC – Multinational Corporations

OECD – Organisation for Economic Co-operation and Development

SEE – South Eastern Europe

TNC – Transnational Corporation

UN – United Nations

UNCTAD – United Nations Conference on Trade and Development

UNMIK – United Nations Interim Administration Mission in Kosovo

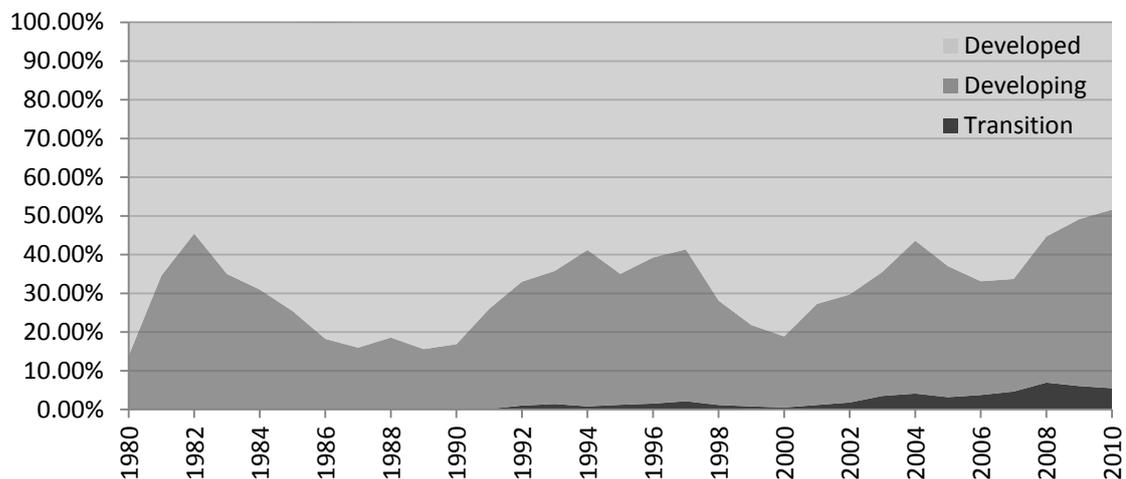
WB – World Bank

## Introduction

Economic growth rates have dramatically improved in both developing and transition countries. Foreign direct investment (FDI) followed particularly by the liberalisation processes have become the key source to facilitate the endeavour of achieving a sustainable economic growth and the integration to the world economy.

The recent up surge of foreign flows reproduced a greater intensity of cross-border mergers and acquisitions reflecting higher growth rates and impressive economic performance mainly for developed and developing countries when compared to transition economies, this due to the higher participation they have in the worldwide flow. In contrast, the share of transition economies in inward FDI has become noticeable recently since throughout 80`s and early 90`s countries concerned did not manage to overcome even the level of 1 percent. Only after 2007 and onward transition shores started to attract foreign flows above the 5 percent level. The share rose from 0.5 percent since 2000 to 6.04 percent in 2009 and 5.48 in 2010 respectively.

Figure 1. The distribution of inward FDI



Source: UNCTAD data

Key characteristic of 2010 is that for the first time developing and transition economies jointly absorbed more than half of global foreign inflows which increased by 5 percent in the respective year. Promising prospects<sup>1</sup> reveal that the importance

<sup>1</sup> (UNCTAD, 2011)

of foreign flows in transition countries is steadily growing while inequalities between borders are constructing rough competition to attracting such financial resources as hypothetically it is conceivable that the presence of such inflows affords a channel for capital insertion, technology and knowledge transfer upon which was built the belief that for further economic development FDI is a *sine qua non*<sup>2</sup>. As justification the policy regimes in most countries were enhanced in the form of barrier reduction and the reinforcement of relationships between multinational enterprises (MNE) and local firms was promoted through exceptional incentives since the presence of such inflows helps the alleviation of resource and skill constraints.

Therefore, exploiting determinants of foreign flows for transition economies is a task of special importance throughout this study. The empirical analysis covering 27 transition and post-transition economies differs from existing studies by a richer set of variables used ranging from market indicators such: market size, trade openness, total labour force and costs; macroeconomic stability measured by real interest rate and GDP deflator, fiscal policy corresponding to corporate income tax rate, including also the importance of the level of corruption for countries concerned. In addition, empirical findings are used as extension in support of analyzing the case of Kosovo lying in a fairly competitive region, which despite socio-economical problems is still trying to attract foreign investors.

The thesis is organized as follows. Section 2 introduces the theoretical framework of FDI and its pattern into transition economies, section 3 discusses about the FDI-growth nexus, determinants and incentives for FDI while section 4 discloses in details the empirical research conducted for transition economies. Section 5 introduces the economy of Kosovo and all processes it went through starting from the post-war period, touching the act of independence declaration and the period after. In this section the accomplishment of comparative analysis allows to assess whether the offered incentives were sufficient for Kosovo to challenge regional countries in the struggle to attract foreign flows. Last but not least important, section 6 concludes giving the criticism and suggestions for the case of Kosovo in particular.

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<sup>2</sup> Something absolutely needed.

## Theoretical framework of FDI

Among numerous attempts towards the formulation of a unified definition of foreign direct investments as benchmark stands the definition formulated by Organisation for Economic Co-operation and Development (OECD). According to OECD (1996), the term implies the objective of acquiring a lasting interest in an enterprise (“direct investment enterprise”) operating in any economy other than that of a resident entity (“direct investor”). A long term alliance connecting the enterprise and the direct investor by the use of managerial influence reflects the lasting interest while transactions between involved parties (the investor and enterprise) that occur throughout the life starting from the initial founding capital and other successive transactions taking the form of capital reflect direct investment (OECD, 1996). The organisation as a cut off point that establishes the existence of direct investment recommends the 10 percent ownership of ordinary shares or voting stock. Under the same source, a direct investment may take the form of an incorporated enterprise (a subsidiary or associate company) or unincorporated enterprise (branch).

Virtually, several analyses have put forward the question: “Why transnational corporations (TNC) invest in developing and transition economies?”. A very simple answer is given by Culahovic (2000). The study assembles all motives that make foreign investment occur into three groups:

- “Better serving of existing and new customers,
- Increase of competition, market share and profitability,
- Better access to resources”.

Prior conferring about the driving forces that make FDI take place it is mandatory to first recognise the purpose it serves. Generally, FDI falls into three classes: vertical, horizontal and diversifying. A very brief synopsis for each of the forms is provided below:<sup>3</sup>

Vertical (cost minimising) – is the form at which FDI intends the internalisation of production chain within a TNC. Utilizing optimally the host country comparative

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<sup>3</sup> For a detailed overview see (Caves, 1996).

advantages (labour costs, resource endowments, etc.) is the chain mean of the vertical production and this is achieved while locating different stages of production in different countries. The chief target is to export the product either back to the country of origin or elsewhere rather than reaching the local market. In other words FDI substitutes the home country production.

Horizontal (market oriented) – is the case where FDI is focused to meet the needs of local market. Plants that already exist in the country of origin are just duplicated in the host country.

Diversifying – identifies FDI in none neither horizontal nor vertical form. This type involves the mechanism of risk reduction for assorted activities that do not engage any positive synergy on the revenue or cost side. Theoretically it does not add any value to the shareholders since they have the opportunity to compile a well diversified portfolio of shares from different companies. Sometimes, due to the information asymmetry among management and shareholders the step of FDI diversification is undertaken even though it does not represent any direct interest for shareholders.

Regardless the form it takes, benefits that FDI conveys to the host countries may be noteworthy, including knowledge and technology transfer to labour force and domestic firms, productivity spillovers, a more rigorous competition and the improved access for exports remarkably towards the source country. Consequently countries aiming to maximize above mentioned benefits put into practice two types of policies: incentives or restrictions. The main purpose of incentives is to abolish obstacles that are much easier to be created rather than removed.

Thus, both theoretical and empirical studies inspect a wide horizon of variables that have been put forward to explain the behaviour of FDI. A considerable number of variables are reviewed under the hypothetical form while few others are extracted from the economic perception.

## The pattern of FDI into transition economies

Transition economy is the one which is moving from a centrally planned regime to a market based direction. The transformation course starts with economic liberalization where prices are set via demand and supply interaction, the privatisation process that pushes state owned companies into new private ownership, and the transformation of financial sector with independent monetary institutions which ensure the free movement of capital and aspire the macroeconomic stabilization (a more disciplined fiscal and monetary policy). In 2000, the International Monetary Fund (IMF) listed 29 countries as transition economies.

Table 1. Transition economies as of year 2000

<u><i>Transition economies in Europe and the former Soviet Union</i></u>	
<b>CSEE</b>	Albania, Bulgaria, Croatia, Czech Republic, FYR Macedonia, Hungary, Poland, Romania, Slovak Republic, Slovenia
<b>Baltics</b>	Estonia, Latvia, Lithuania
<b>CIS</b>	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan
<u><i>Transition Economies in Asia</i></u>	
Cambodia, China, Laos, Vietnam	

Source: ((IMF), 2000)

In 2002, World Bank (WB) considered for the first time Bosnia and Herzegovina as well as Serbia and Montenegro in the list of transition economies whereas Mongolia and Kosovo were integrated no earlier than 2009. Except additions, countries that joined European Union (EU) had completed the transition process therefore they were excluded from the list in 2004.

Table 2. Current transition economies

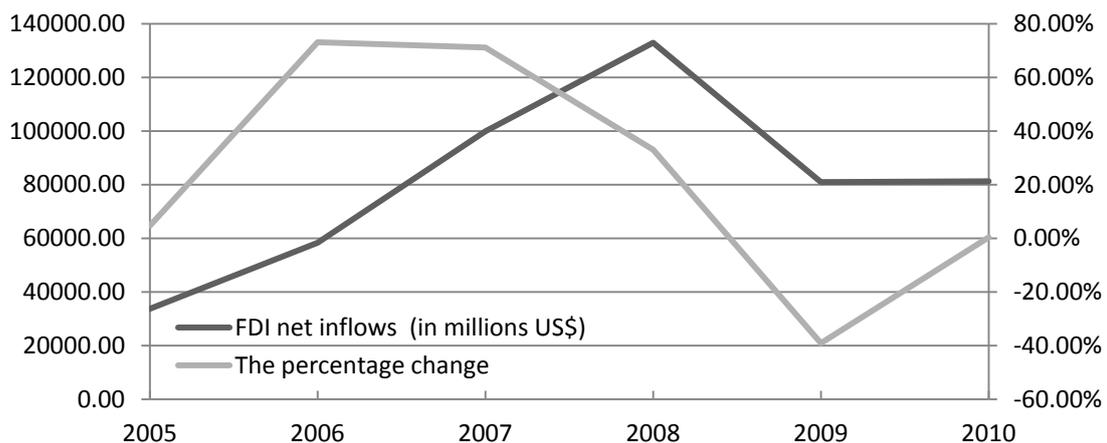
<u><i>Transition economies in Europe and the former Soviet Union</i></u>	
<b>SEE</b>	Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Kosovo, Montenegro and Serbia
<b>CIS</b>	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan
<u><i>Transition Economies in Asia</i></u>	
Cambodia, Laos, Vietnam, Mongolia	

Source: The author based on various sources

On account of recent progress CEE region has levelled up and left behind the group of SEE countries that because of political conflicts and numerous other barriers have stalled to demonstrate a steady economic development and still are facing difficulties in attracting FDI.

The percentage change of inward FDI in transition economies has shown a sharp improvement in 2006 accounted for 73.08 percent, growth that continued throughout the year 2007 (71.13 percent) also. However, global financial crisis of 2008 seemed to have sluggish the prosperity path when diminishing the growth to only 33.11 percent and referring it to negative values for 2009. 2010 accounts for a stabilisation since the calculated increment relative to previous year is only 0.37 percent, the level has not recovered back to pre crises period.

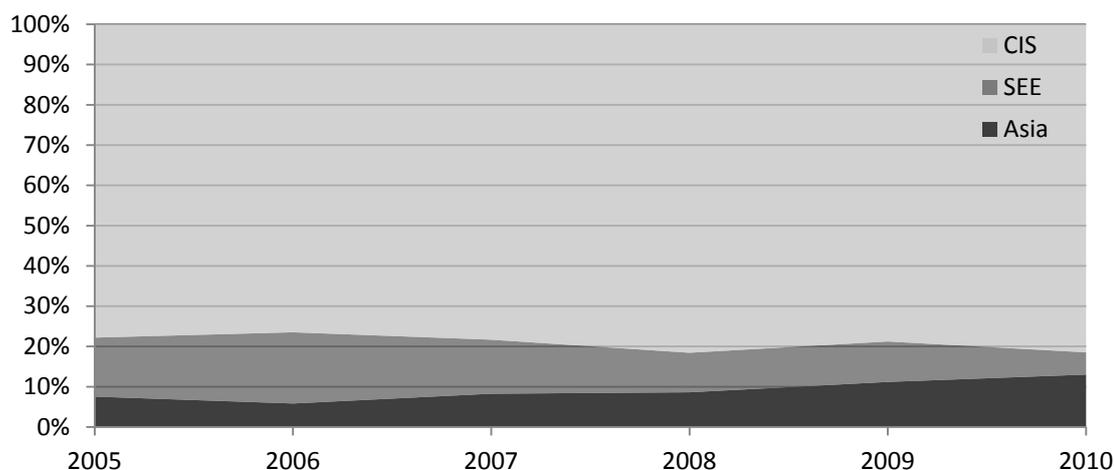
Figure 2. The pattern of FDI into transition economies



Source: World Bank Data

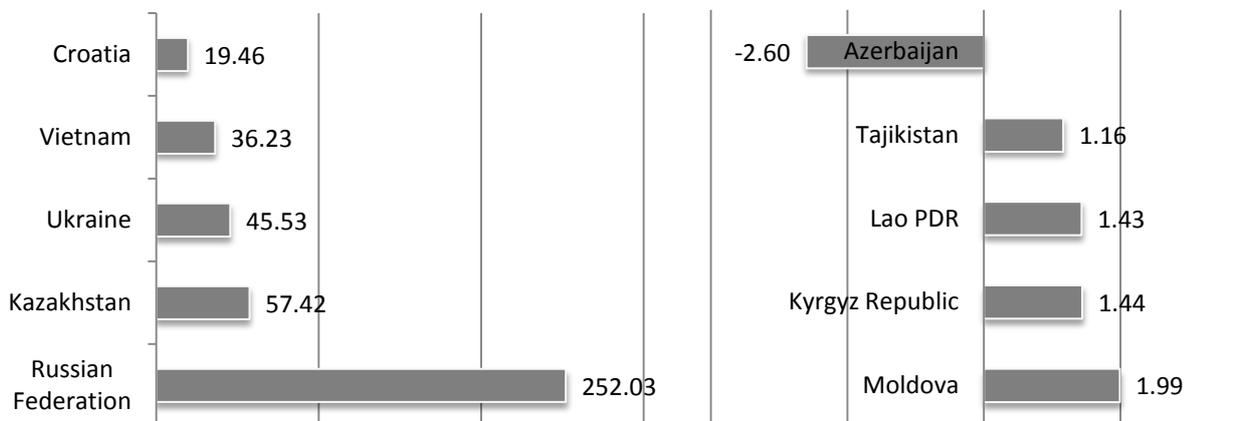
Judged from a regional standpoint the distribution of flows is unequal, this due to high applicable differences in country specifics (the stage of transition, fiscal and monetary policy, business climate, etc.). The imbalanced distribution in cumulative inflows exists even across economies of the same region, countries that have relied their economic development on FDI are tended to have a higher share compared to those that preferred to be based on domestic resources (high-income countries).

Figure 3. The regional distribution of FDI net inflows



Source: World Bank Data

Figure 4. Five largest and smallest cumulative FDI net inflows in transition economies, 2005-2010 (in millions US\$)



Source: World Bank Data

The UNCTAD (2011) report ranks Russian Federation as the main transition economy investing in developing countries while Turkey, China, India and the Republic of Korea as most important investors in transition economies. Moreover, one third of total Turkey’s outward FDI stock was placed in transition economies in 2009, while for China and the Republic of Korea the share reached only the level of 2-3 percent, according to UNCTAD 2011.

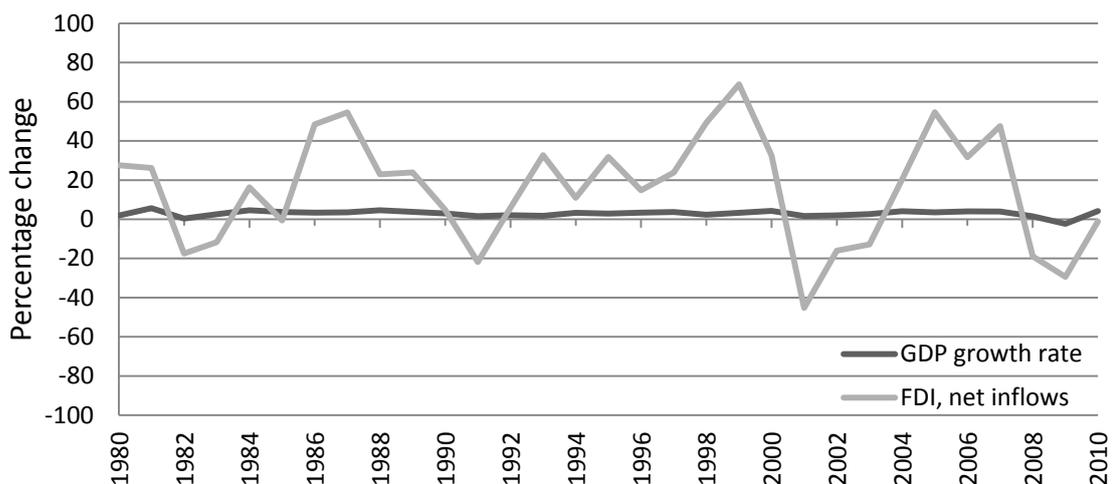
## Why transition economies necessitate FDI?

### The growth-FDI nexus

Physical capital is the mainstay indicator for economic progress. The higher is the portion of GDP invested the faster the country will develop. In order to invest country must have a gap between the income and general consumption level denoting savings, or have access to foreign funds. Countries with high rates of unemployment and low salaries do not possess such capacity. Thus, theoretically there are three channels at which these countries may incorporate sufficient foreign investments. First and the most important is the attraction of foreign companies to directly expand the activity in the country. Secondly, policymakers may stimulate the growth by increasing debt obtained either via open market operations or financial institutions such IMF or World Bank and the last source might be the assistance from industrialized countries.

The WB data among 1980-2010 has shown that the worldwide average of FDI growth per annum was 15.31 percent, while the world GDP on average improved for only 2.93 percent annually alleging the existence of positive correlation that may incur between economic growth and FDI.

Figure 5. The percentage change of worldwide GDP and inward FDI



Source: World Bank Data

Amid policy makers there is a consensus that FDI is a leading variable of GDP long run trends. However, growth may be negatively affected by FDI level as it is

capable to degenerate the competition and orient the economy towards the unfortunate path. In contrary it is expected that the economic growth may encourage FDI development through the demand side as long as improvements in demand initiate higher profit ratio and in this occasion capital inflows are attracted.

The neo-classical analysis does not explicate the long run growth rate as subject of FDI. Since foreign flows are exogenous, the increased presence is immediately translated into new capital per labour which in turn means more output, but this is a temporary outcome given that diminishing returns which apply on the marginal product of capital create constraints into growth. Basically, only the simultaneous augmentation on the labour force or technological improvement in interaction with FDI can speed up the long run growth.

In meanwhile, the analytical examination provided by Narula and Portelli (2004) suggests that FDI is not a sine qua non indicator asserting that the principle was reinforced only by the experience of newly industrialised countries. Nevertheless, without underestimating the probable contribution of FDI en route for income growth and factor productivity this study highlights the evidence that foreign inflows instead of substituting local factors are capable to only complement their role for economic development.

Several studies that have been made at firm, industry or state level notify that technical improvement and the adoption of technological knowledge are significant catalyst of economic growth. In addition, considering that technology diffusion plays an immense role in relation to economic development the importance of FDI becomes even greater. Technology diffusion concerns the adoption and implementation of new technologies in line with pioneering countries, and foreign investment through multinational corporations (MNC) is accounted to be the major source for the technology transfer.

The empirical research intended to uncover effects of FDI on economic growth and the conduit through which it may be beneficial for growth suggests a positive relation towards growth pinpointing that the magnitude of this effect depends on the stock of host country human capital. The cross country regression covering 69 least developed countries (LDC) emphasized that FDI promotes domestic

investment due to the fact that creation of complementary activities drives the behaviour of domestic competitors which in turn is less productive compared to foreign investment (Borensztein, et al., 1995).

A number of studies propose that only developed countries are likely to take the advantage from FDI (Borensztein, et al., 1995), while some others suggest in favour of LDCs (Blonigen, et al., 2004). What is the current state of findings for transition economies?

Campos, et al. (2002) tested for effects of foreign investments on growth in a set of transition economies at which FDI reflects a pure transfer of technology. Regressing the real GDP growth subject to initial income, human capital, FDI, quality of infrastructure and growth rates over OECD countries the study brought up the conclusion that 1 percent increase in FDI boosts the growth rates between 0.5 and 1.5 percent. When controlled for endogeneity problem the link resulted to be even stronger adding that growth proceeds from FDI is independent from the threshold level of human capital (Campos, et al., 2002).

Despite, the abundant availability of host country human capital in instantaneous interaction with FDI is qualified as growth effective source. The analysis made at country level has revealed that transition economies such is the case of Ukraine, with spacious human capital and a tendency to attract foreign flows may benefit greatly on the way to impact the economic growth. The analysis also has shown that the lagged level of FDI does not have any significant and persistent impact on day to day economic growth, while the opposite relation holds also (Aleksynska, et al., 2003).

Nath (2009) using the fixed effects approach conducted a study for 13 transition economies of CEE and Baltic region over 1991 to 2005 time period and found a significant and encouraging effect of trade on growth of per capita real GDP while the level of foreign flows did not appear to have such an attribute. Rather than foreign, growth has tended to be much more stimulated by domestic investment (Nath, 2009).

Investigating the nature and the effect of FDI on economic growth, Katerina et al. (2004) applied the Bayesian analysis into 17 transition economies (including

Albania and Bosnia) for the four-year period (1995 – 1998). The outcome indicated the non existence of any important relationship between FDI and growth. Attempting more robust results the sample was divided into low and high income growth countries but even after the exclusion of outlier cause, prior results did not exhibit any consequential change. Therefore, there was found no positive nor negative relationship between economic growth and the level of FDI in transition economies (Katerina, et al., 2004).

Stanisic (2008) records the effect on export performance and economic growth as probable product of foreign direct investment and cites that both economic variables are key indicators in prospects for accession of transition economies in the EU. A study over 7 transition economies of SEE (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania and Serbia & Montenegro) for the period starting from 1997 to 2006 was incapable to show any positive correlation between the economic performance and FDI. There are two reasons that explain the lack of statistical relationship among foreign flows and economic growth for transition economies. First, there is a chance that results suffer from methodological mediocrity and secondly findings are accurate. The latter puts forward the conclusion that there is no positive effect on growth arising from FDI. A more straightforward explanation finds the increasing inefficiency in production and unemployment in domestic firms as key source that offsets the positive impact of FDI on host country economic growth (Stanisic, 2008).

Another study with a larger sample size, alongside 25 CSEE transition economies including: Albania, Bosnia and Herzegovina, Macedonia and Serbia and tried to establish the relationship between FDI and economic growth for the period 1990-2005. The fixed effects estimation has revealed that the lagged level of FDI and GDP positively affect the host country economic growth while current level of FDI is a negative one consequence. The outcome is explained as a result of delay in spillovers coming in the form of know-how and technology transfer (Sapienza, 2009).

Türkcan et al. (2010) using panel data for 23 OECD countries over the period 1975-2004 have built a two-equation simultaneous system and concluded that the unilateral judgement in favour of FDI towards growth or the reverse relation is

unreliable due to the endogeneity problem. Therefore, a bi-dimensional relation among economic growth and FDI was captured suggesting that both economic variables determine the behaviour of each other simultaneously.

Given that different conclusions are drawn across studies concerning the extent at which the presence of FDI supports the economic growth, yet there is a theoretically supported consensus for a positive and strong correlation between FDI and country economic growth.

### Determinants of FDI into transition economies

Given that today's world economy is considered as highly dynamic the rigid behaviour of micro and macroeconomic linkages is impersistent, therefore various interactions are continuously being drawn across studies. While for a specific group of countries there is a positive correlation between two variables for some others there is no statistical significance or negative interaction is involved. This paradigm will be holding as long as countries differ significantly from each other. Dunning (2003) supposed that: "... countries differ from each other in respect of their stage of development and propensity to attract international business, according to their environment (E), economic systems (S) and government policies (P)."

UNCTAD (2002) has shaped the determining variables of inward foreign investments as shown in the table below.

Table 3. Classification of FDI Determinants

Type	Variable
Policy variables	Tax policy, trade policy, privatisation policy, macroeconomic policy.
Market-related economic determinants	Market size, market growth and, market structure.
Resource-related economic determinants	Raw materials, labour cost, technology.
Business Variables	Investment incentives.
Efficiency-related economic determinants	Transport and communication costs and labor productivity

*Source: (UNCTAD, 2002)*

According to IMF (2003), investors are motivated in different ways while facing the location decision. Apart this, determinants vary also across the economic sectors. As general factors that determine which emerging market countries (EMC) pull the most FDI are cited as follows:

“• Market size and growth prospects of the host country play an important role in affecting investment location since FDI in EMCs is increasingly being undertaken to service domestic demand rather than to tap cheap labour.

- Wage-adjusted productivity of labour, rather than the local labour cost, will increasingly drive efficiency-seeking investments of “footloose” firms that use EMCs as export platforms.

- The availability of infrastructure is critical. EMCs that are best prepared to address infrastructure bottlenecks will secure greater amounts of FDI.

- Except in some sectors, tax incentives (holidays) do not play an important role in determining investment location, although reasonable levels of taxation and the overall stability of the tax regime do.

- A broad consensus in the host country in favour of foreign investment is an important consideration for investors. In this context, a reasonably stable political environment, as well as conditions that support physical and personal security, is an important benchmark that is used in judging the likelihood of adverse changes in the investment climate for foreign-owned firms.

- Corruption and governance concerns have a significant bearing on investment prospects. The investment regime and the environment for business—including the business licensing system, the tax regime, and the attitude and quality of the bureaucracy—are vital.

- Recent crises have magnified perceptions of regulatory risks and greater attention is now being focused on the legal framework and the rule of law. A predictable legal system, which among other things respects the sanctity of contracts and facilitates a level playing field, will further enable EMCs to secure large amounts of FDI on a sustained basis.”

Due to the highlighted variation that crops up across economies many studies exploit the determinants of FDI using panel data analysis, while quite often

developing and transition economies are mutually examined. Çevis et al. (2007) developed an empirical framework employing a panel from both types of economies and raised the awareness about the advantages that panel data analysis provide compared to cross-section and time series. A better control for heterogeneous individual effects, a lower degree of collinearity among predictor variables and the gain in efficiency of estimators are listed as the main precedence. Including 17 countries over the period 1989-2006 the analysis captured the interaction of seven economic variables. Signifying a pull factor for host countries the lagged level of FDI to GDP has resulted to be an important determinant. Similarly, it is concluded that FDI is positively correlated with the real interest rate indicating the rising country's risk somewhat confirmed by the theoretical underpinnings. The higher the risk the higher the return would be, thus the rising interest rate is seemed to be pulling factor of FDI. The growth rate measuring the change of demand for goods and services that is translated into a higher rate of productivity and profitability as well as trade openness are found to be positively related while the rising labour costs measured as percentage change of wages and the inflation rate asserting country's macroeconomic risk appear to impede FDI. A similar study was developed by Nonnemberg, et al, (2004). The panel analysis covered 38 countries including transition economies over the period 1975-2000 and brought up the conclusion that the size of the economy represented by GDP, and the average rate of growth during previous years do strongly encourage inflows, likewise the level of schooling that demonstrated a big deal for countries on the way to attracting knowledge-intensive activities. The economy's degree of openness proved to be positive-significant whereas inflation as an indicator of macroeconomic stability provided negative evidence. This study pointed out also the association that FDI have with stock market performance.

Apart the non differentiation between economies, many studies try to focus completely in the transition world. A range group of transition economies with a special emphasis for Macedonia through static and dynamic models was analyzed by Zulfiu (2008). Even though the first model falls behind the autocorrelation problem the empirical evidence reports the income level of the host country as an important

determinant, the unit labour costs having a positive relationship while gravity factor explained as the distance between capital cities of source and recipient country appeared with a negative and significant coefficient. Despite the fact that macroeconomic stability of Macedonia embodied by the low rate of inflation did not indicate any attraction symptom for the influx, the gain in efficiency of the legal system has shown positive impact. The second method suffers from the lack of variation due to the very small data set thus a more robust conclusion is absent. However, being strongly supported by previous studies these findings can be accepted as reliable only and only with caution (Zulfiu, 2008).

Virtually all empirical analysis find that gravity factors such market size and the distance between involved countries are very important factors. The gravity model only with trade flows is able to explain about 60 percent of aggregate FDI flow (Demekas, et al., 2005). As gravity factors are exogeneous variables with greater explanatory power, the efforts of host country policymakers certainly must be important too. A predictable and credible policy environment that projects macroeconomic stability, the enforcement of rule of law, the elimination of distortions in spite of competitiveness support might in turn encourage the development of private sector including the foreign investment. Demekas, et al. (2005) examined the way that policies can support the effort en route for FDI in SEE and conveyed the finding that the policy environment matters for further FDI attraction. High unit labour costs and corporate tax burden and the application of high tariffs for imports have resulted to be inversely related whereas a liberal foreign exchange and the reformation of infrastructure tends to withdraw a higher share of foreign sources. In addition to this, the creation of tax holidays and corruption index do not carry any statistical implication.

Carstensen, et al. (2004) evolved a dynamic panel data analysis covering CEE countries over the period starting from 1993 to 1999. The evidence aimed to point out factors that encourage or impede the flow coming from OECD countries to seven transition economies. Market potential is found to be a strong positive indicator as comparative advantages such: corporate tax rates, relative endowments and low unit labour costs did. A skilled labour force is highlighted as influential factor most

probably due to its crucial role to the operationalization of innovative production technologies and the exposure to a western business civilisation. Nonetheless, it was suggested that traditional variables were not sufficient to describe the presence of FDI in the CEE countries. The involvement of the privatization method as a proxy for the corporate governance quality and the level of privatisation captured as a share of private market increased the coefficient of determination at a greater extent. Also, uncertainties arising from political, legal and economic environment are found to be important variables for the reason that they clarify the country risk (Carstensen, et al., 2004). In this pattern, Baniak et al. (2005) tried to explore the importance of legal environment vis a vis FDI in transition countries. The study relied in two economic variables: the exchange rate and the production costs that practically depend on the performance of macroeconomic indicators and judicial regulations. For instance, the probability distribution of the first variable relies upon inflation and the deficit of budget, trade and the balance of payment while corruption, the level of wages, taxation and social system determine the probability distribution of marginal production costs. The argument built is that the increased volatility of any of two variables implies diminishing expected utility which in turn accelerates the downturn of foreign flows. Moreover, the analysis comes across the problem of attracting right investors considering them as participants in stable and long run investments. Arguing about the position of firms towards the risk it was concluded that investors are not risk neutral but are risk averse instead and not identical too (Baniak, et al., 2005). Due to the speculative outlook that is enforced by the economic instability, it is very likely that the expected utility from future returns could be relatively small for serious long term investors while satisfactory for firms that love the risk (less risk averse). For this reason the unstable economic position leads to investor adverse selection meaning that firms with no long run plans are interested to invest in the host country only for the speculative purpose.

According to Bevan, et al. (2000), announcements of country progress in EU accession also guide the pattern of FDI inflows to the CEE countries for the period between 1994 -1998. The analysis revealed that accession announcements did not improve directly the country credit ratings but a dynamic transmission entails the

intermediate impact upon FDI which with one lag period improves country credit rating, and the improved credit rating in the current period improves FDI on the onward period. In addition to this, it is found that the unit labour costs, the market size and gravity factors influence at a significant extent the presence of FDI.

Campos, et al. (2003) while trying to pinpoint factors that matter for the geographical diversification of FDI among 25 transition economies for the period starting from 1990 till 1998 ended up with three classes of determinants. First is constituted by country specific advantages (domestic market, skilled and low cost labour force, adequate infrastructure and the distance regarding the Western European markets), the second category deals with macroeconomic policy and other institutions that aim the improvement of business operating environment and the last class falls behind the persistency of FDI driven by agglomeration economies. Key finding is that agglomeration economies and institutions play an important role in determining the location of FDI. The possession of abundant natural resources, bureaucracy quality and the low labour costs are positively interrelated with FDI whilst the increment in transaction costs unfavourably influences it. Difficulties related to the enforcement of law resulted to justify the absence of foreign flux which in contrary is encouraged by countries characterized with a higher degree of trade openness and a lower level of restrictions with regard to FDI.

Nonetheless, statistical data concerning CEE transition countries has clearly shown that there is a huge gap of flows across both zones. Bandelj (2002) compares country characteristics with a relational access that stresses political, economical, institutional and cultural relations between host country and the investor. Empirical results provide a light support for the cross country characteristics. Trade, political and cultural relations as well as migration play a strong constructive effect on foreign flows while accounting considerably for the cross variance explanation (Bandelj, 2002). Hence, social relations substantially allow for the understanding of delay and tight integration of some economies into the pace of competitors.

Table 4. Summary of selected empirical studies: Determinants of FDI into transition economies

Determining variable	Impact on FDI		
	Positive	Negative	Statistically insignificant
Lagged level of FDI	(Çevis, et al., 2007) (Zulfiu, 2008)		
Growth rate	(Çevis, et al., 2007) (Nonnemberg, et al., 2004) (Türkcan, et al., 2010)		
Trade openness	(Çevis, et al., 2007) (Nonnemberg, et al., 2004) (Campos, et al., 2003)		
Market size	(Demekas, et al., 2005) (Carstensen, et al., 2004)		
Labour costs	(Zulfiu, 2008)	(Çevis, et al., 2007) (Demekas, et al., 2005) (Carstensen, et al., 2004) (Baniak, et al., 2005) (Campos, et al., 2003)	
Inflation		(Çevis, et al., 2007) (Nonnemberg, et al., 2004) (Demekas, et al., 2005) (Baniak, et al., 2005)	(Zulfiu, 2008)
Real interest rate	(Çevis, et al., 2007)		
Level of schooling	(Nonnemberg, et al., 2004) (Carstensen, et al., 2004)		
Tax burden		(Demekas, et al., 2005) (Carstensen, et al., 2004) (Baniak, et al., 2005)	
Tax holidays			(Demekas, et al., 2005)
Infrastructure	(Demekas, et al., 2005)		
Distance between involved countries		(Zulfiu, 2008) (Demekas, et al., 2005)	
Corruption	(Baniak, et al., 2005)		(Demekas, et al., 2005)
Political environment	(Carstensen, et al., 2004) (Bandelj, 2002)		
Legal system	(Zulfiu, 2008) (Demekas, et al., 2005) (Carstensen, et al., 2004) (Campos, et al., 2003)		

## Incentives for FDI attraction

Policies that are implemented by countries are proficient to assist or impede the path of foreign flows. In other words, the provision of various incentives may abolish administrative and other barriers for investors and positively affect flows of FDI. Incentives that are designed to attract investors are deemed as locational and practically deal with taxes, tariffs, subsidies, profit repatriation and the establishment of Investment Promotion Agencies (IPA).

The power of incentives capturing the outcome of transaction between firms and the government is vague and consequences are with mixed results since incentives referring to the cost-gap prevailing among countries are likely to be comparatively small and in this case ineffective. Therefore, both theoretical and empirical studies by providing diverse results have failed to accomplish a more clear-cut framework.

The remaining part of this section presents the theoretical and empirical framework of corporate income tax and other incentives separately. The study puts special emphasis in tax incentives since this variable is taken into consideration throughout empirical analysis.

## Tax incentives

Under the Tiebout's law, fiscal rivalry let individuals exert their activity in locations offering the amalgamation of both tax and public goods at the most satisfactory level. Tax competition that intends the enlargement of the tax base persists until countries reach the optimum point which in turn allows them to minimise the cost of public goods (Tiebout, 1956). Tax competition is defined as a technique that arranges a tax rate reduction or the execution of partial exemption schemes in order to attract investors and enlarge the tax base, if not investors would agree to pay high tax rates if and only if it serves for better infrastructure or public services.

The theory of tax competition is built under the assumptions of perfect competition and firm mobility and it is not necessarily associated with the inefficiency

since it compels the rationalization of public expenditure. In sum, tax differences would not impact the location decision if they basically equate differences in infrastructure or the quality of services. Wilson (1999) sums up findings from literature review on tax competition as the following:

First, the increasing tax rate in one region is basis for positive externality to neighbouring countries. Because not every government considers such externalities, their socially optimal level appears to exceed taxes.

Second, when regions differ in size also, being small is a benefit since large regions face fragile reaction of the capital cost with regard to tax rates. Demand for capital is hit by increasing tax rates so does its price (it is compensated for the tax change). Thus, being a smaller region is an advantage.

Lastly, principles of double taxation have different inferences for the place of activity. A full credit scheme, equivalent to a government affording full tax credit for abroad paid taxes does not have any economical reasoning. Given that the payoff of foreign investors is not worsening, the host country may increase tax rates similarly the source country would do in order to limit the compensation of excess tax. Then the result of Nash equilibrium would collapse in high taxes for both economies at which capital flows would not take place.

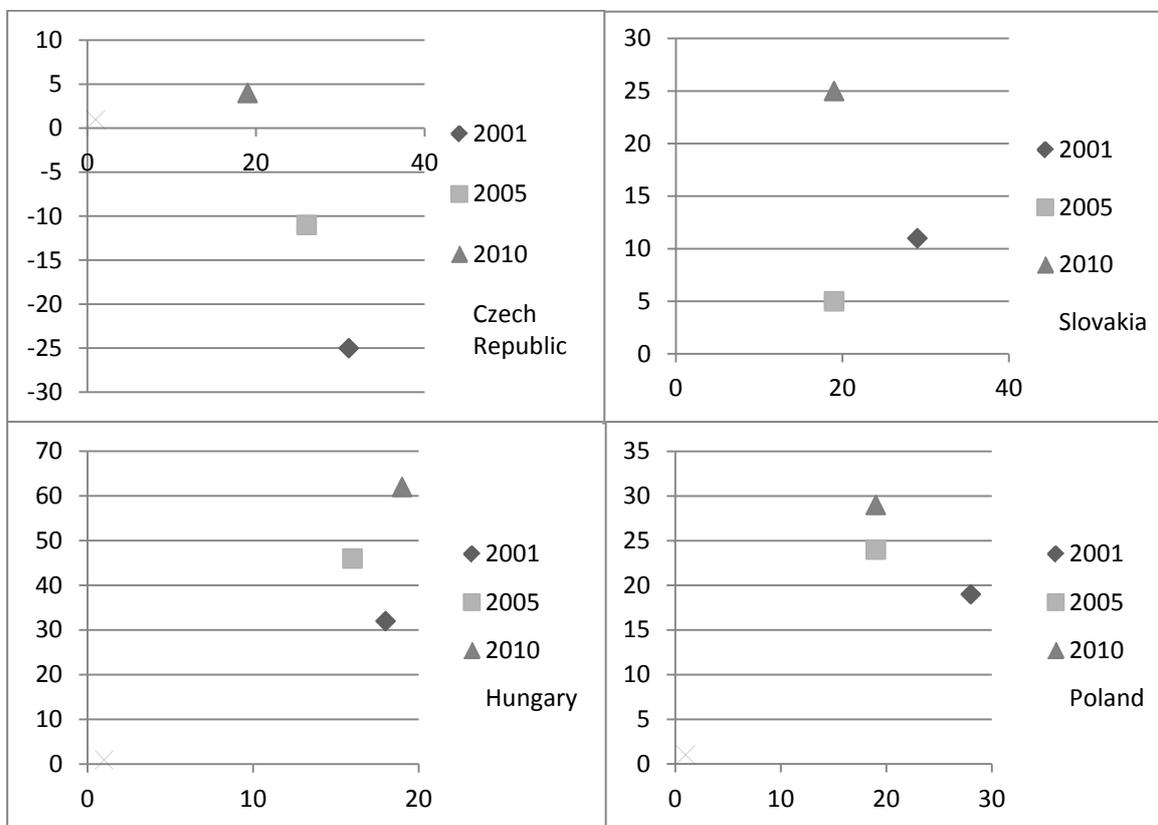
Depending on the kind of tax incentive, results are dissimilar on condition that every tax rate has different collision on FDI. Boura et al. (2006) has categorized tax incentives as the following: value added tax, corporate income tax, tax holidays, import tariffs, property tax, royalty payments and depreciation allowances.

Findings about the effectiveness of tax incentives remain fairly inconclusive as fiscal policy entails the threat of disruptive effects. It happens that some specific industries or firms will possibly benefit from changes of tax-burden and others seek for identical treatment. The puzzle concerns the effectiveness of supplied incentives, because costs that the government undertakes are not automatically equivalent with benefits.

The most innovative incentive throughout 90s was the promotion of corporate income tax reduction. Countries have strived to downward the pressure coming from the tax burden by applying lower tax rates and made it a significant

factor affecting the decision of foreign investors related to location allocation. Along these lines, many studies put emphasis on the host country corporate tax.

Figure 6. Corporate tax reforms between four Central European countries



x-axis presents corporate income tax  
y-axis presents net national debt as share of GDP

Source: OECD data

The figure reveals the continuity of competition through tax reforms even in recent years. The evolution of corporate tax as a tool of fiscal policy in the battle to attract foreign investors indicates that the four Central European economies are approaching to a common point even though the cost they are paying in order to maintain competitiveness is relatively high. The OECD data are evidence for increasing national debt that might be a consequence of contraction in revenues generated by payments made on behalf of corporate income tax.

According to Zhang (2005) what is to be concerned about is the case at which regional countries end up playing the bidding game resembling that of “prisoner’s dilemma” at which benefits of foreign investors are covered by the expenditure account of triumphant country and its citizens welfare.

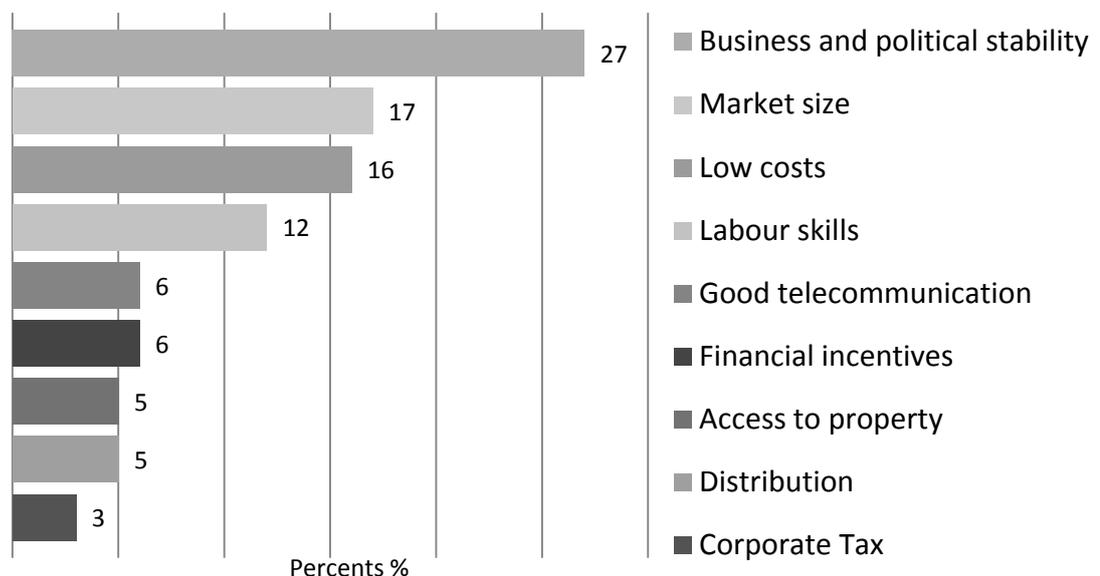
In addition, Janeba (2002) states that foreign firms face the trade off between investing in low-“cost and credibility” and high-“cost and credibility” country. The study argues that if investors are attracted by politically risky countries in equilibrium the tax rate they pay is the same as that of a politically credible country, therefore finding a significant effect empirically for the tax variable may be a hard task as taxes adjust endogenously (Janeba, 2002).

Empirical results are somewhat uncertain, they are mixed due to comparatively small advantages that countries supply therefore literature is fairly inconclusive. Wei, et al. (2000) finds empirically that the corporate income tax does not have any statistically significant effect to attract foreign flows.

**Other incentives**

Principal factors that weight for the generation of foreign flows are related with specific policy frameworks that improve business and economic outlook of the country. As given by Culahovic (2000) what matters from the foreign investor’s point of view is presented in the following figure:

Figure 7. Factors that influence the location selection



Source: (Culahovic, 2000)

According to Culahovic (2000), factors are grouped into three sets. The first one requires a policy framework that stabilizes the macroeconomic and legal status

of the host country, the fairness of privatization process and its discernible progress as well as the reinforcement of international relations by means of bilateral investment treaties (BIT) that avoid double taxation and political risks. The second set is a composition of those factors that influence the performance of business such is the availability of a reliable set of information about the country and its readiness to be served on time, country's international image and the ease of administrative procedures in doing business. And the last stands for factors capturing the economic nature of the host country such labour costs and skills, market size and growth, natural resources, the quality of infrastructure, the access to bordering and regional markets and social amenities (Culahovic, 2000).

Cass (2007) names fiscal and financial incentives and the establishment of IPAs as extensively used tools for FDI attraction. The data for 27 transition economies using specially constructed scales reveals that the use of incentives is strongly enhanced from the mid 90s suggesting that the recent falls in tax rates for few countries are reversed by the new EU enlargement. In addition the study finds that the use of incentives is not only to equilibrate disadvantages regarding the business climate but it is influenced by international competition too and the utilization of IPAs is a catalyst of progress for transition economies (Cass, 2007).

Blomström, et al. (2003) argues that promotion efforts are mainly encouraged by transitory macroeconomic difficulties such as low growth rate or high unemployment rate. The study finds the compilation of efficient programs for FDI stimulus as complicated task for governments suggesting the possibility of profits shifting from host countries to foreign firms. Besides, the use of incentives substantially motivated from theoretical underpinnings is not found to be the most appropriate way to lift the national welfare, this due to incapacity of local firms to expand further existing investment base and absorb foreign skills and technologies. Therefore, it is suggested that the support of investment and learning in local firms should be given simultaneously with subsidization of foreign investors (Blomström, et al., 2003).

Pioneering the work made on defining and identifying the role of an IPA, Wells, et al. (2000) describes the investment promotion in condition of "promotional

techniques” which encompasses the provision of information to potential investors, creation of an attractive image for the country and affording services to future investors (Wells, et al., 2000). Commonly these functions are realized by a single agency (IPA) but sometimes promotional techniques engage other sources of support such are economics ministries or embassies and quite often promotional agencies may exercise other activities such is the case of export promotion. Responsibilities of an IPA are explained in an adaptive form in the following table:

Table 5. Functions of investment promotion agencies

	Function	Description	Example of means
“Classical” IPA tasks	Investor facilitation and investor services	Assisting an investor to analyse his decision, establish a business and ensure it continues to operate.	Provision of information, assistance in getting approvals, assistance with sites, utilities etc.
	Image building	Creating the perception of a country as an attractive site.	Advertising and public relations.
	Investment generation	Targeting specific sectors and companies in order to create investment leads.	Identification of targets direct contact, forums, seminars etc.
Policy-related Activities	Policy advocacy	Supporting initiatives to improve the investment climate and identifying private sector views.	Surveys, participation in task forces, policy proposals, lobbying.

Source: (Morisset, et al., 2004)

## Empirical Analysis

Initially, the purpose of this study was to cover only the case of the Republic of Kosovo in the course of any time series analysis given that there is no such study to date. However, due to the very short period of time running from the end of war (1999) and the lack of data for the post-war period this target remains nothing less than a taboo. Consequently, the research uses the panel data analysis to empirically examine the economic determinants of FDI.

### Data description

The data set used comprises 27 economies between 2003-2010 time period. The reason why this time frame is chosen was subject of the data availability for Kosovo and the objective to keeping the data set strongly balanced in both time and cross country dimensions. The first limitation is justified by the fact that this study includes for the first time Kosovo in any empirical analysis of this kind whereas the latter is of technical nature that facilitates the process of testing for the stationarity of series since unit root tests do not support unbalanced panel data sets.

The cross section sample principally covers transition economies as well as new member states of the EU representing the group of countries in the advanced stage of `transition` characterized with a higher level of data quality compared to countries that have undergone the process of economic liberalisation recently, among which is the case of Kosovo itself. Countries observed in this study are 27 in total, as: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Republic of Kosovo, Kyrgyz Republic, Latvia, Lithuania, FYR Macedonia, Moldova, Mongolia, Poland, Romania, Russian Federation, Serbia, Slovak Republic, Slovenia, Tajikistan, Ukraine and Vietnam. Besides, for countries such: Cambodia, Kazakhstan, Lao, Turkmenistan and Uzbekistan the lack of data meant that countries in question were not able to account for the analysis.

The empirical study incorporates nine variables in which one is dependent and the remaining constitutes the set of explanatory variables. If not in percentage points, variables measured in monetary base are expressed as share of GDP since effects are transformed into real rather than nominal-unadjusted terms. Source of all macroeconomic variables is the World Bank, corruption indicator is extracted from the Worldwide Governance Indicators while corporate income tax emerges from various surveys.

By all means the choice of dependent variable felt on FDI net inflows as share of GDP. Foreign net inflows are investments that acquire a lasting management interest of minimum 10 percent of voting stock in an enterprise operating in any economy other than that of source. It is the sum of equity capital, reinvested earnings, and other forms of long and short term capital as shown in the balance of payments.

The utilized variables to explain FDI in transition economies were:

The previous year real GDP growth rate (GDP\_1) – this variable represents the growth rate of the sum of gross domestic product added by resident producers in the economy and captures increasing demand for goods and services, it is used as an indicator of market size. A positive sign of coefficient is expected as long as this variable is directly considered as a pointer of rising productivity and profitability therefore. For the reason that there is no clear cut association between dependent variable and GDP (the existence of bi-dimensional relationship or causality between variables) the study uses one year lagged value. Even though this approach turns to be quite costly when considering the loss of observations (one per each cross section) it still avoids the potential problem of endogeneity.

The degree of trade openness (TRADE) – is the sum of exports and imports as share of GDP and captures the openness of economy which is expected to have a positive impact into FDI, the more opened the economy is the higher the portion of foreign flows would be.

Inflation (INF) – showing the percentage price change in the economy as a whole compared to consumer price index (CPI) which considers a more narrowed

basket. GDP deflator is used as a measure of price stability and as a good quantifier of country's macroeconomic risk its impact is expected to be negative.

Real interest rate (RIR) – is the lending interest rate adjusted for inflation. It represents the price of money and its rising paths indicate rising macroeconomic risk. Empirical developments have shown its inexplicit impact therefore its sign is expected to be either positive or negative. Along these lines, by including both real interest rate and inflation measured by GDP deflator the decomposed effect of lending interest rate given by Fisher equation will be captured in a roundabout way.

Remittances (REM) - embodies transfers by migrant workers adjusted for wages and salaries earned by non-resident workers. This variable is put up as a proxy for labour costs that could be measured more precisely by average monthly wages, variable that is found hard to be constructed for countries concerning this study. The logic behind is quite straightforward, the lower the wages are the higher transfers by migrants would be, therefore a positive rapport of remittances towards FDI means that low wages have positive impact in the latter.

Labour force (LabF) – the growth rate of labour force composed by employed and unemployed people who meet the definition of economically active population measures the impact of growing labour force in FDI. A positive relation is likely to crop up as the abundant labour force may drive costs due to excessive demand on the market.

Corporate income tax (CIT) –measured in percentage points, the variable expresses the portion of net profits each company as a subject to tax has to disburse. Representing a business variable its coefficient sign is absolutely expected to be negative meaning that countries that apply high corporate tax rates are keen on attracting less foreign flows.

Control of corruption indicator (CoC) – reveals the extent at which public power is put into effect for private gain. The indicator ranges from -2.5 to 2.5 and the higher it is the stronger the governance performance is estimated to be, therefore a positive sign of the coefficient is rationale since low level of corruption may explicitly be perceived as a favourable marker of host country socio-institutional environment.

## Panel Unit Root Tests

In order to avoid spurious regression analysis we test the series for non-stationarity. According to Baltagi (2008) there are two factors that may mislead results drawn from unit root test: 1) the presence of structural breaks in time series and 2) seasonal adjustments imposed into the data. The first complication is what threatens the analysis more as long as the episode of last global financial crises is involved in the data analysis. In addition to this, allowing for considerably short individual time series the hypothesis of no unit root is much more a matter of assumption rather than an outcome of reliable statistical inference.

Still we apply Levin, Lin and Chu (LLC) t-test; Im, Pesaran and Shin (IPSHIN) W-stat test; Augmented Dickey-Fuller (ADF) and ADF-GLS Chi-square test and results for each series are given in the table below.

Table 6. Results of Panel Unit Root Tests

Variable	Test	ADF	ADF-GLS	LLC	IPSHIN
<b>FDI</b>		60.827 (0.2477)	184.148 (0.0000)	[-8.405] (0.0007)	[-0.636] (0.2620)
<b>GDP</b>		53.744 (0.4842)	161.517 (0.0000)	[-12.681] (0.0000)	[-3.468] (0.0000)
<b>TRADE</b>		55.628 (0.4133)	159.482 (0.0000)	[-7.316] (0.0000)	0.091 (0.5360)
<b>REM</b>		84.298 (0.0052)	194.038 (0.0000)	[-8.821] (0.0000)	[-1.095] (0.1370)
<b>RIR</b>		98.173 (0.0002)	293.024 (0.0000)	[-13.100] (0.0000)	[-4.265] (0.0000)
<b>INF</b>		93.780 (0.0006)	262.439 (0.0000)	[-13.424] (0.0000)	[-4.504] (0.0000)
<b>CoC</b>		72.235 (0.0493)	199.093 (0.0000)	[-9.229] (0.0000)	[-1.903] (0.0290)
<b>CIT</b>		X	X	[-8.052] (0.0000)	[-1.662] (0.0480)

Although applied tests confirm the hypothesis of no unit root in each series we still hereby notify that this stance remains more as a subject of assumption.

## Econometric model

The objective of this section is to outline the econometric model and the used methodology to empirically test effects of the aforementioned variables. Due to characteristics of the data the analysis fell to any of panel data models that explain the variation of dependent variable by combining the specific information of individuals (countries) evolving over time. These models are precious as they do not disband idiosyncrasies arising among countries, in different words they allow for group heterogeneity.

Generally, a panel data regression appears in the following form:

$$y_{it} = \alpha + \beta^T x_{it} + u_{it}$$

Where:  $i=1, \dots, N$  and  $t=1, \dots, T$

The explained variable  $y_{it}$  is represented in the model by FDI net inflows as share of GDP, and  $\beta$  is a vector representative for the set of explanatory variables varying in  $i$  and  $t$ , where  $i$  stands for cross sections (countries) and  $t$  for time.

More specifically we have:

$$\beta = [\text{GDP}_1, \text{TRADE}, \text{INF}, \text{RIR}, \text{REM}, \text{LabF}, \text{CIT}, \text{CoC}]$$

As a starting point to get familiar with the nature of the data pooled OLS estimation is employed for the reason that its diagnostics allow to control for the multicollinearity dilemma and it is a good source signalling for efficiency gain if estimation is made via any other model applicable to the panel data.

The correlation matrix (available in Table 1.-Appendix) of variables shows TRADE with the highest correlation coefficient relating FDI while there is a high negative correlation between RIR and INF but a high degree of correlation between variables does not necessarily imply collinearity that is why the variance inflation factor (VIF) as a more formal method of multicollinearity detection is applied. Statistical software's suggest that values higher than 10 indicate a collinearity problem whereas literature tends to be more restrictive as it halves the value into 5 (Judge, et al., 1982). Regardless, results (available in Table 2.-Appendix) do strongly

reject the presence of multicollinearity in the regression as values range in 1 to 3.7 interval.

As pointed earlier, in the challenge to find a more efficient model we use the outcome of tests obtained from pooled OLS model.

Table 7. Diagnostics for the basic model

Test	Results
<b>White</b>	LM=46.7464 p-value=P(Chi-square(35)>46.7464)=0.0885
<b>Wald</b>	Chi-square(27) = 12790.2 p-value = 0
<b>Joint significance F</b>	F(26, 155) = 2.0141; p-value= 0.0047
<b>Breusch – Pagan<sup>a</sup></b>	LM = 2.32088; p-value=P(chi-square(1) > 2.32088)=0.1276
<b>Hausman test<sup>b</sup></b>	H=14.5428; p-value=P(chi-square(7) > 14.5428)=0.0423

FDI as share of GDP is regressed in all variables excluding INF

<sup>a</sup> A low p-value counts against the null hypothesis that the pooled OLS model is adequate, in favour of the fixed effect alternative.

<sup>b</sup> A low p-value counts against the null hypothesis that the random effects model is consistent, in favour of the fixed effects model.

Model specification tests recommend fixed effect (FE) model to be the most appropriate one. The joint significance F-test favours the use of FE versus pooled OLS as Hausman test does when random effect (RE) model is questioned.

Standard tests of homoskedastic disturbances (White and Wald) reject the hypothesis of constant errors variance. White test as a more general test asserts the presence of heteroskedasticity without specifying whether its form is homoscedastic within units (homoscedastic in time) and varying across units only, or both forms are present. The presence of heteroskedastic disturbances across units (groupwise heteroskedasticity) is confirmed by Wald test. Accordingly, the estimated OLS parameters are consistent but not efficient and its standard errors are inflated and of no use given that they produce misleading inference.

Countries that appear in the role of cross sections are quite heterogeneous they differ greatly in size, the stage of economic development and consequently they exhibit different variations, therefore the assumption of homoskedastic disturbances seems to be very restrictive to hold for panel data (Baltagi, 2008).

Taking into account shortcomings of pooled OLS we opt the use of groupwise heteroskedasticity model which is nothing else than a feasible generalized least squares (FGLS) on panel data that allows for groupwise heteroskedasticity. The advantage of this model is that it performs most likely iterated weighted least squares on a panel data set without requiring any knowledge concerning the precise source of heteroskedasticity and weights are calculated based on per unit error variances. Results obtained from different estimation models are reported in the following table.

Table 8. Panel Data Models for FDI

	Pooled OLS	Pooled OLS	Groupwise WLS				
<b>GDP_1</b>	0.0429 [0.0982] (0.6623)	0.0738 [0.0981] (0.4526)	0.0905 [0.0389] (0.0214)**	0.1116 [0.0381] (0.0038)***	0.1129 [0.0380] (0.0034)***	0.1128 [0.0377] (0.0032)***	0.1142 [0.0366] (0.0021)***
<b>TRADE</b>	0.0392 [0.0195] (0.0463)**	0.0389 [0.0197] (0.0503)*	0.0203 [0.0066] (0.0027)***	0.0210 [0.0073] (0.0048)***	0.0214 [0.0065] (0.0013)***	0.0215 [0.0065] (0.0011)***	0.0220 [0.0063] (0.0007)***
<b>INF</b>	0.3163 [0.1489] (0.0351)**		0.2581 [0.0576] (0.0000)***				
<b>RIR</b>	0.1960 [0.1327] (0.1413)	-0.0245 [0.0833] (0.7689)	0.1730 [0.0584] (0.0035)***	-0.0230 [0.0339] (0.4981)	-0.0240 [0.0339] (0.4796)	-0.0221 [0.0337] (0.5124)	
<b>REM</b>	0.0044 [0.0755] (0.9531)	0.0466 [0.0735] (0.5268)	0.0673 [0.0364] (0.0663)*	0.0896 [0.0355] (0.0125)**	0.0875 [0.0316] (0.0063)***	0.0893 [0.0317] (0.0054)***	0.0857 [0.0298] (0.0045)***
<b>CIT</b>	-0.1596 [0.1069] (0.1373)	-0.1117 [0.1055] (0.2912)	-0.0762 [0.0464] (0.1025)	-0.0801 [0.0457] (0.0814)*	-0.0838 [0.0421] (0.0482)**	-0.0798 [0.0420] (0.0594)*	-0.0754 [0.0405] (0.0648)*
<b>CoC</b>	0.0180 [0.0145] (0.2161)	0.0013 [0.0123] (0.9122)	0.0148 [0.0058] (0.0124)**	0.0009 [0.0049] 0.8547			
<b>LabF</b>	0.1012 [0.2790] (0.7172)	0.1109 [0.2816] (0.6941)	0.0988 [0.1397] (0.4801)	0.0057 [0.1334] (0.9659)	0.0038 [0.1332] (0.9771)		
<b>Constant</b>	0.0196 [0.0318] (0.5383)	0.0381 [0.0308] (0.2180)	0.0162 [0.0109] (0.1416)	0.0385 [0.0110] (0.0006)***	0.0386 [0.0109] (0.0005)***	0.0375 [0.0109] (0.0007)***	0.0352 [0.0103] (0.0008)***
<b>Obs.</b>	189	189	189	189	189	189	189
<b>R-squared</b>	0.0607	0.0372	0.2517	0.1964	0.1942	0.1944	0.2068

Values between square brackets represent the standard error.

Values between parentheses represent the p-value.

\* Indicates statistical significance at 1 percent level.

\*\* Indicates statistical significance at 5 percent level.

\*\*\* Indicates statistical significance at 10 percent level.

The reason why two models are developed in parallel is the positive sign of INF variable which is somewhat unexpected. Majority of studies have concluded that inflation is inversely related with the level of FDI, finding is theoretically supported too. In contrary, Kinoshita, et al. (2004) comes at the same occurrence and explains the positive sign of inflation as an outcome of potential endogeneity. If this situation applies then results from the regression including INF variable are biased and incapable to explain the phenomenon properly. For testing purpose the regression is run in CPI as well and results appeared to be alike. Hereupon, we consider results from the model with seven explanatory variables to be more robust and strong enough to explain the variation into FDI. Prior to interpreting results the study tests the regression stability meant for the reason introduced at unit root tests section.

### Tackling the structural break

As long as policies and the state of economy are stochastic processes, econometricians are aware that relationships may perhaps change over time too. As the breakdown period (2008-2010) is included in the data set used to modelling the behaviour of FDI, results are questionable and should be tested for stability. To examine the point, one would use either Chow test which is an F-test or the time dummies method. The first is based in three regressions, one which is estimated over the whole sample period (the restricted model) and two others formed by dividing the sample on the date when the event takes place (in this case study the partition point is the year 2008). A drawback of Chow test is that it requires the break-date to be known, indeed one should be aware of lagged effects that may mislead the procedure of break point establishment. As a consequence the use of dummy approach is more appropriate; adding the equivalence with Chow test it becomes even more convenient for use. Table below shows results from the original model and the second one which includes six dummy variables, as to deliberately avoid dummy variable trap.

Table 9. Testing for structural break, restricted and unrestricted models

	Groupwise WLS Restricted Model	Groupwise WLS Unrestricted Model
<b>GDP_1</b>	0.1116 [0.0381] (0.0038)***	0.0128 [0.0146] (0.8441)
<b>TRADE</b>	0.0210 [0.0073] (0.0048)***	0.0120 [0.0081] (0.1434)
<b>RIR</b>	-0.0230 [0.0339] (0.4981)	0.0708 [0.0422] (0.0956)*
<b>REM</b>	0.0896 [0.0355] (0.0125)**	0.0610 [0.0323] (0.0605)*
<b>CIT</b>	-0.0801 [0.0457] (0.0814)*	-0.0255 [0.0477] (0.5937)
<b>CoC</b>	0.0009 [0.0049] 0.8547	-0.0005 [0.0055] (0.9256)
<b>LabF</b>	0.0057 [0.1334] (0.9659)	0.0242 [0.1242] (0.8457)
<b>Constant</b>	0.0385 [0.0110] (0.0006)***	0.0348 [0.0146] (0.0184)**
<b>D_2005</b>		-0.0014 [0.0082] (0.8646)
<b>D_2006</b>		0.0175 [0.0083] (0.0367)**
<b>D_2007</b>		0.0280 [0.0084] (0.0011)***
<b>D_2008</b>		0.0168 [0.0085] (0.0512)*
<b>D_2009</b>		-0.0167 [0.0087] (0.0555)*
<b>D_2010</b>		-0.0174 [0.0116] (0.1370)
<b>Observations</b>	189	189
<b>RSS</b>	172.6752	146.3221

The joint significance of dummy variables is tested through F-test. The probability associated with the calculated F-value (5.2530) is quite low, accordingly the regression is structurally unstable meaning that the evolution of FDI is explained

differently during pre and along the crisis period. In order to formulate a more secure assessment Chow test is also conducted, and results have just confirmed the already established position that allows for structural break (Calculations for both tests are available in Table 3.-Appendix).

Below are presented results obtained from two subsamples the one starting from 2003 to 2007 and the other from 2008 to 2010.

Table 10. Subsample Panel Data Model for FDI

	Groupwise WLS Pre-break	Groupwise WLS Post-break
<b>GDP_1</b>	0.1807 [0.1208] (0.1380)	0.0042 [0.0366] (0.9082)
<b>TRADE</b>	0.0242 [0.0109] (0.0297)**	-0.0205 [0.0102] (0.0505)*
<b>RIR</b>	0.0319 [0.0505] (0.5290)	-0.0401 [0.0458] (0.3858)
<b>REM</b>	0.0782 [0.0508] (0.1268)	0.0258 [0.0730] (0.7249)
<b>CIT</b>	-0.1309 [0.0756] (0.0866)*	0.0198 [0.0719] (0.7840)
<b>CoC</b>	0.0086 [0.0084] (0.3093)	-0.0166 [0.0064] (0.0136)**
<b>LabF</b>	0.1170 [0.1642] (0.4775)	0.0743 [0.1655] (0.6556)
<b>Constant</b>	0.0453 [0.0168] (0.0082)***	0.0461 [0.0184] (0.0160)**
<b>Observations</b>	108	54
<b>R-squared</b>	0.2424	0.3046

## Empirical findings

Overcoming the data barriers this study covering 27 transition and post-transition economies investigates empirically the true effect of seven variables into foreign flows. Taking into account the heterogeneity arising across countries the most appropriate model is found to be the groupwise heteroskedasticity which is nothing else than a feasible generalized least squares (FGLS) on panel data that allows for groupwise heteroskedasticity.

Furthermore, as the breakdown period (2008-2010) was included in the data set used to modelling the behaviour of FDI, results are tested for stability. To this point, both Chow test and the time dummies technique suggest the presence of structural break meaning that the fashion of FDI is determined differently depending on the economic propensity. Therefore, we find more convenient to interpret results as a contrast of two episodes while the main relations obtained can be summarized as the following:

- The past path of GDP growth matters only at times of economic prosperity, throughout economic crises investors do not base their decisions on growth prospects because most likely countries miss the targets and this does not indicate that the future will be analogous.
- Trade openness greatly drives the decision related to location selection, meaning that open economies perform better in terms of attracting foreign investors.
- The corporate income tax is inversely related with foreign flows significantly. Therefore, countries with lower corporate tax burden are tended to be shores of foreign investors.
- Growing labour force does not influence significantly the presence of foreign flows albeit they are positively interrelated,
- Real interest rate changes its relation towards FDI depending on economic scenario. During times of economic tranquillity it appears to be positively related with FDI while the opposite emerges at the time of economic downturn. Nonetheless, its effect is not significant for any of the cases.

- Low level of corruption is highly welcomed for foreign investors, still its effect is not decisive this due to the insignificance of estimated coefficient.

Additionally, the negative sign of TRADE variable and the opposite for CIT are two outcomes suitable for further consideration. The first can be interpreted as a relation between trade openness as a channel of risk transmission and FDI, case for which investors would prefer much more closed economies during times of economic difficulties while the latter may be a miscalculation caused by insufficient number of observations and consequently the incapacity of the model to account correctly small differences among countries, a pure product of “tax convergence” among transition economies.

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## The case of Republic of Kosovo

### Overview of the Republic of Kosovo

Ruined at almost every point as a result of last appalling conflict, Kosovo began to feel the amity no earlier than mid 1999. Since then, for the purpose to maintaining peace, building the democracy and stability, United Nations (UN) authorized the operation of United Nations Interim Administration Mission in Kosovo (UNMIK) until a final status was determined. Under the reliance of 1244 Resolution this intervention was the first of its kind.

The mission consisted of four pillars, amongst which one was compiled for reconstruction and economic development and was left under the responsibilities of European Union (EU). Its aim was the construction of a transparent and market oriented economy, in other words foundations of transition period were set up by this time. Important is that the pillar considers the competitiveness degree with regional countries as the most important building block to attract foreign investment as a globally scarce resource. Initially, fiscal and other economic policies were in charge of UNMIK, a provider of support in form of advices for banking sector too.

Parallel to this, the united mission had been working in the direction of institutionalization. First parliamentary elections were held in 2001, marking a new era that consolidated for the first time institutions with clearly defined responsibilities. Accordingly, over the time when assessed that conditions were ripe responsibilities were handed over the relevant local bodies.

No earlier than 17th February 2008, in conformity with all international partners the Assembly of Kosovo declared the independence. The act has successfully passed the test of law violation vis-a-vis International Court of Justice and is recognised by 91 UN countries to date<sup>4</sup>. The independence is perceived as a positive impulse, proficient to assist the ongoing efforts for economic development.

The newest democratic country in Europe sits amid Albania, Macedonia, Serbia and Montenegro.

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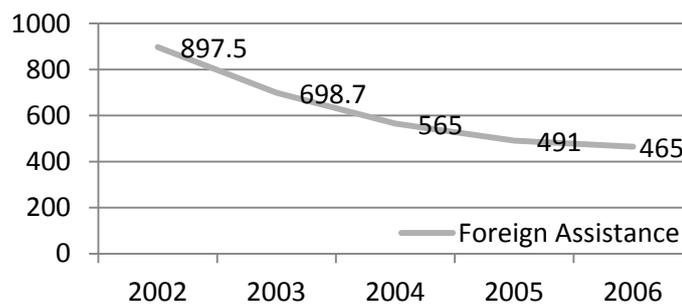
<sup>4</sup> 15/07/2012

## Kosovo`s economy

The end of ethnic cleansing conflict, finds Kosovo with a damaged infrastructure, destructed agricultural and industrial production and a withered financial sector incapable to process even the most basic transactions as wages are. This situation came up due to NATO air campaign, which targets were not only on delicate points such are military bases but also in industries and infrastructure in both countries Kosovo and Serbia (Castillo, 2008).

In 1999, World Bank estimates raised a need for reconstruction at 2.3 billion dollars for the next four to five years horizon. As per beginning, the tremendous injection of foreign assistance and private inflows had supported the fast economic recovery at a satisfactory level.

Figure 8. The trend of foreign assistance (mil €)



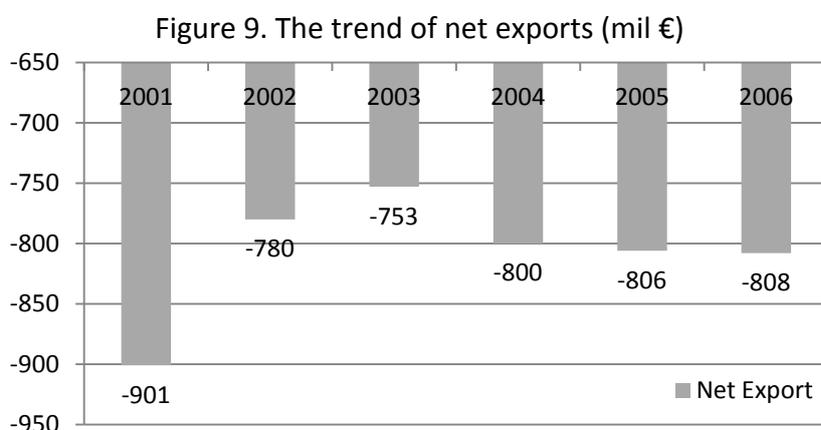
Source: (IMF, 2007)

Throughout the reconstruction period foreign assistance was fairly high creating an excessive dependence on donor funds able to build a fragile economy within unstable sources since the flux was in a constantly down turn afterwards. For the reason that inflows were majorly focused on areas with low-late rate of return such: public services, housing, education, infrastructure, health and justice services the growth rate of real GDP had stagnated considerably for a long period then, a typical situation of post conflict countries.

Moreover, in order to sustain steady economic growth Kosovo needed to keep even at a higher level public investment for the reason that the efficiency ratio measured by incremental capital output (ICOR) was a concern over the three years to 2006. Productive countries have an ICOR of 4 approximately, but Kosovo had 16.1 meaning that the production of an additional unit of output involved a requirement

of 16.10 dollars extra capital. However, this indicator was not to be considered as an essential predictor of future productivity since the economic scenery was rapidly changing (USAID, 2008).

Ever since then, the economic development is confronted by the high deficit of trade balance and high rate of unemployment. Moalla-Fetini et al. (2005) considers that the utilization of donor funds had created an artificial `export` as the treatment of local goods and services purchased by the international staff and soldiers facilitated the poor exposure to regional markets.



Source: IMF, Aide Memoire (2007)

The graph shows how deep the trade deficit was during 2001-2006 period of time. The decline of foreign assistance was followed by a decrement in exports while at that time Kosovo was exporting base metals and their articles, mineral products and importing foodstuff, beverages, tobacco, mineral products, machinery, mechanical appliances, vehicles and transport equipment mainly.

Still, Kosovo faces continuous difficulties regarding the exposure of its products in regional markets and elsewhere. The government has been working to set up the basis of market economy that ensures the free movement of goods and services. Since 2006, Kosovo is part of Central European Free Trade Agreement (CEFTA) that gives access to a market of 30 million consumers. Additionally, based on the EU Autonomous Trade Preference (ATP) the country benefits also from non reciprocal customs free access to the EU market whereas a considerable number of goods take the advantage of preferential handling in the US market.

Despite all these efforts, the CEFTA agreement does not apply in precision given that the presence of Kosovar products in the regional market is hampered by Serbia and Bosnia and Herzegovina. That is why calculations in the table attached below show that country has the most closed economy in the region. The data starting from 2005 to 2010 straighten this uncomfortable position noting that Kosovo has on average the lowest share of imports and exports to GDP in region.

Considering the growth rate of real GDP, the economic growth appears to be solid and comparatively more sustainable. Accompanied by Albania, Kosovo was characterized by economic growth even along the current global crisis (2009) and later on it has transcended the whole region without excluding Albania in this district.

On the other hand, the WB (2010) report declares Kosovo as the poorest country in Europe with GDP per capita of only €1,760. The report suggests that in order to attain the income level of Albania, Kosovo should double the rate of economic growth into 10 percent for next ten years and again this is feasible only and only if Albania keeps growing at a rate of 5.5 percent along the same period. At the same time, to catch up the level of GDP per capita of Montenegro, the economy should grow even faster. The same source states that growth should maintain the rhythm of 12 percent for a decade.

Over and above, the high rate of unemployment is another serious threat. According to Kosovo Agency of Statistics (KAS), estimates have shown that the unemployment rate reached the level of 45% for 2010 fiscal year. At this point, Kosovo is a regional leader tripling the average of Albania and standing far behind Bosnia and Herzegovina and Macedonia which although in the unenviable position has managed all the time to reduce the level of unemployment.

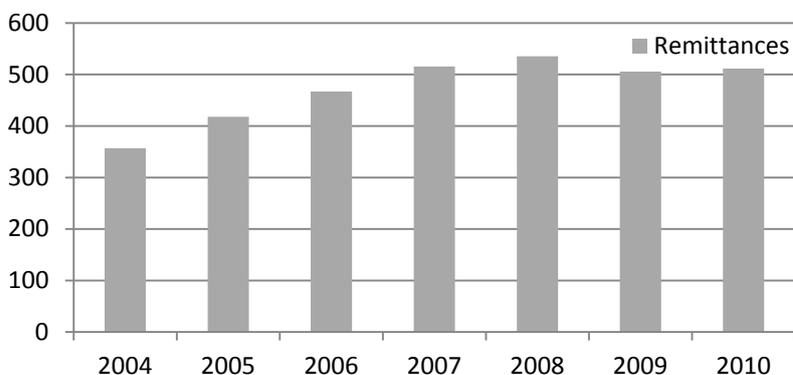
Accordingly, considering that labour costs are very low, the available labour force might be an advantage for investing in Kosovo. The survey of Alliance of Kosovar Business (AKB) reveals that the average net salary for public sector in 2010 was estimated to be only €268, while for private sector it increased to €303 in 2010 from that of 2008 which was only €243. Remaining the lowest in the region, this level of salaries is the reason why half of the population is living below the poverty line when extreme cases are becoming more and more frequent in rural areas. However,

Country	Year	Real GDP	GDP growth	GDP per capita	GDP per capita growth	Population	Unemployment rate	Lending interest rate	Real Interest reat	Inflation GDP deflator	Trade openness
Albania	2005	4793518371.51	5.50	1525.72	4.93	3141800.00		13.08	9.28	3.47	68.60
	2006	5033194290.08	5.00	1594.50	4.51	3156607.00		12.94	10.73	2.00	74.24
	2007	5330152753.20	5.90	1681.61	5.46	3169665.00	13.50	14.10	11.84	2.02	83.74
	2008	5740574515.19	7.70	1804.42	7.30	3181397.00	13.00	13.02	8.30	4.36	85.63
	2009	5930013474.20	3.30	1857.35	2.93	3192723.00	13.80	12.66	10.68	1.79	82.83
	2010	6137563945.79	3.50	1915.00	3.10	3205000.00		12.82	9.05	3.46	81.53
Average		5494169558.33	5.15	1729.77	4.71	3174532.00	13.43	13.10	9.98	2.85	79.43
Bosnia and Herzegovina	2005	7012968256.56	5.00	1854.79	5.01	3781001.00		9.61	7.33	2.13	105.61
	2006	7447772288.47	6.20	1969.48	6.18	3781588.00	31.80	8.01	1.63	6.28	103.84
	2007	7957050957.55	6.84	2105.58	6.91	3779034.00	29.70	7.17	0.45	6.69	123.53
	2008	8388323119.45	5.42	2222.56	5.56	3774164.00	23.90	6.98	-0.63	7.66	119.02
	2009	8144222916.68	-2.91	2161.60	-2.74	3767683.00	24.10	7.93	7.91	0.02	86.23
	2010	8209376700.01	0.80	2183.34	1.01	3760000.00	27.20	7.89	6.61	1.20	92.67
Average		7859952373.12	3.56	2082.89	3.65	3773911.67	27.34	7.93	3.88	4.00	105.15
Kosovo	2005	2619069794.57	3.84	1482.21	3.26	1767000.00	41.40	14.00	15.35	-1.17	
	2006	2776213982.25	6.00	1562.30	5.40	1777000.00	44.90	14.57	17.01	-2.09	64.84
	2007	2951115463.13	6.30	1653.29	5.82	1785000.00	46.30	14.06	10.79	2.95	68.75
	2008	3154742430.09	6.90	1757.52	6.30	1795000.00	47.50	13.79	7.78	5.58	71.30
	2009	3246229960.56	2.90	1798.47	2.33	1805000.00	45.40	14.09	15.58	-1.29	69.03
	2010	3376079158.98	4.00	1860.10	3.43	1815000.00		14.31	10.94	3.04	81.49
Average		3020575131.60	4.99	1685.65	4.42	1790666.67	45.10	14.13	12.91	1.17	71.08
Macedonia	2005	3877087656.40	4.35	1902.30	4.09	2038109.00	37.30	12.13	8.05	3.77	105.28
	2006	4072129927.20	5.03	1993.12	4.77	2043091.00	36.00	11.29	7.76	3.28	111.08
	2007	4322519752.10	6.15	2110.69	5.90	2047922.00	34.90	10.23	2.61	7.43	123.16
	2008	4536485006.84	4.95	2210.20	4.71	2052524.00	33.80	9.68	2.05	7.49	127.09
	2009	4494737198.35	-0.92	2185.34	-1.12	2056769.00	32.20	10.07	9.32	0.69	99.60
	2010	4575642467.93	1.80	2221.19	1.64	2060000.00	32.00	9.48	7.17	2.16	113.26
Average		4313100334.80	3.56	2103.80	3.33	2049735.83	34.37	10.48	6.16	4.14	113.25
Montenegro	2005	1130670093.49	4.20	1804.05	4.23	626739.00	30.30			4.31	104.62
	2006	1227907721.53	8.60	1958.15	8.54	627074.00		11.15	1.96	9.02	119.75
	2007	1359293847.73	10.70	2164.61	10.54	627962.00		9.20	-3.09	12.68	129.87
	2008	1453085123.22	6.90	2309.47	6.69	629185.00		9.24	1.44	7.68	133.02
	2009	1370259271.20	-5.70	2173.51	-5.89	630435.00		9.36	6.75	2.45	98.65
	2010	1404515752.98	2.50	2222.34	2.25	632000.00		9.53	7.82	1.58	99.18
Average		1324288635.02	4.53	2105.36	4.39	628899.17	30.30	9.70	2.98	6.29	114.18
Serbia	2005	7888605693.00	5.40	2907.08	5.72	7440769.00	20.80	16.83	0.99	15.68	73.34
	2006	8172595497.95	3.60	3023.16	4.01	7411569.00	20.80	16.56	3.61	12.50	81.31
	2007	8613915654.84	5.40	3137.56	5.83	7381579.00	18.10	11.13	0.94	10.10	85.23
	2008	8941244449.72	3.80	3183.99	4.24	7350221.00	13.60	16.13	3.12	12.61	88.70
	2009	8628300893.98	-3.50	3087.53	-3.11	7320807.00	16.60	11.78	5.81	5.64	76.44
	2010	8710641060.74	0.95	3122.11	1.37	7291000.00	19.20	17.30	7.58	9.04	86.29
Average		8492550541.70	2.61	3076.91	3.01	7365990.83	18.18	14.95	3.68	10.93	81.89

Table 11.Key economic indicators for Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro and Serbia based on the World Bank data

this deplorable situation is persistently mitigated by the great support coming in the form of remittances.

Figure 10. The trend of remittances (mil €)



Source: Central Bank of Kosovo

Kosovo's economy can be termed as 'remittance economy' due to enormously large flux of remittances. The chart illustrates growing trend throughout the post war period with exception of 2009 fiscal year. The fall is expressed as a consequence of last global financial crisis, as countries of origin were hit and consequently the providers of funds also.

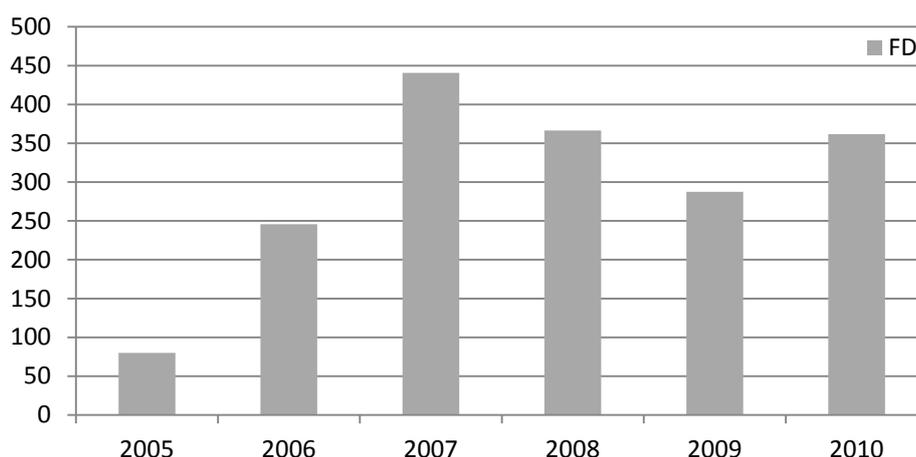
Even though surrounded with all these difficulties, for the moment Kosovo runs a stable monetary policy. The adoption of Euro as official currency has facilitated the resistance for price stability, distinguishing the country for the lowest rate of inflation in the region. More problematic is the rate of real interest which for the period 2005-2010 has fluctuated in the region of 10 -15 percent and reached an average of 12.91 percent. Compared with the rate of inflation it is the highest in the region and remains the main needle that has diminished the rate of return for private sector projects.

Kosovo has also joined formally the WB and IMF on 2009 and since then it has undertaken its share of the Yugoslavia's debt quoad both institutions.

## Foreign Direct Investment in Kosovo

Continued efforts have been made in terms of attracting foreign investors' attention. With time, when political and economic conditions were significantly stabilizing the flow had started to increase considerably. To ease the situation even more, likewise countries in the region Kosovo founded the agency<sup>5</sup> with its main purpose to promote values and opportunities to invest in the country. Among others this agency has defined reasons to invest in Kosovo as follows: central location in the region; young, educated, multilingual and dynamic population; well skilled and competitive labour force; EU- compatible legislation; sound banking system and low tax burden (IPAK 2011).

Figure 11. The trend of foreign direct investment (mil €)



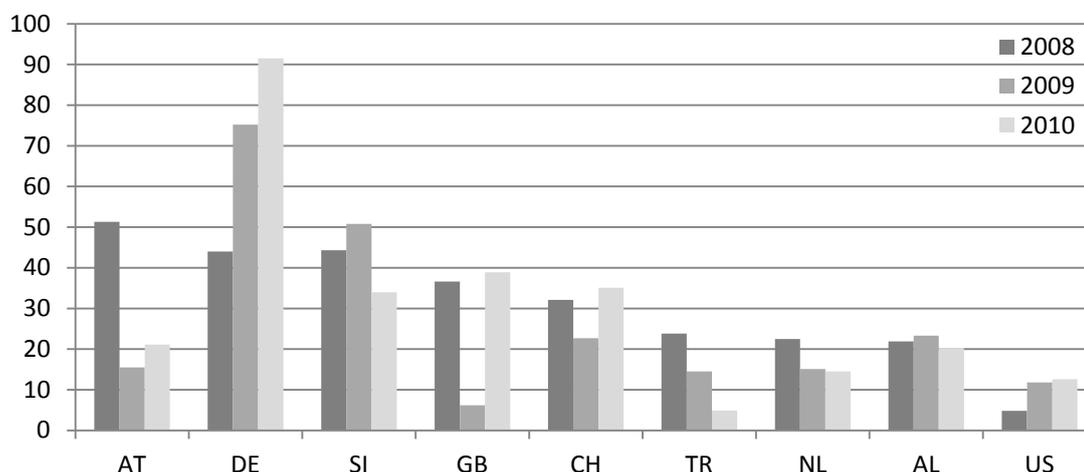
Source: Central Bank of Kosovo

The interest of foreign investors has been progressively increasing until the early 2008 when the act of independence declaration took place. Uncertain political status and fears about any possible conflict have made the entire economy and many other processes to remain stagnant at a large extent. Besides, during 2009 a significant decline was evident too. Except the problem related to the political status this meagre performance is partly explained as a consequence of global recession started in 2008. The period of sensitivity seems to overcome in 2010 when the influx

<sup>5</sup> Investment Promotion Agency of Kosovo - IPAK

began to show again positive signs compared with the previous year, but it didn't attain the pre crises level yet when the flow had reached the peak (2007).

Figure 12. FDI by major countries (mil €)



Source: Central Bank of Kosovo

While examining the origin of flows it is obvious that countries which supported the political situation were more stable in relation to investments. Discerning is the case of Germany which even during the deep recession helped in the recovery of Kosovo's economy. Not so unexpected, the origin of funds is very similar to the origin of remittances sidelining dilemma that the presence of immigrants is effective in promoting the country to foreign investors in the respective countries.

Table 12. Number of foreign enterprises based on countries of origin

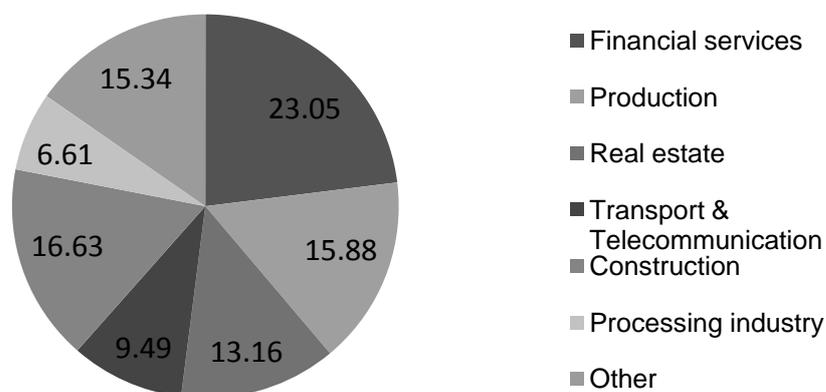
Country	Number of enterprises
Albania	531
Macedonia	438
Turkey	405
China	401
Germany	293
Italy	147
USA	115
Bulgaria	99
Croatia	85
Austria	83

Source: IPAK

The main representative of foreign community is Albania that comprises of 531 enterprises. The second is Macedonia to continue further with Turkey, China, Germany, Italy, USA, Bulgaria, Croatia and Austria ranked as top ten countries.

Measuring from the perspective of economic activity, financial services represent the highest average share since 2007 (23.5 percent). This percentage comes as a result of excellent performance of foreign investment pioneers such Procredit and Raiffeisen banks operating in Kosovo from the early phase of transition. Nevertheless, not only these two are foreign banks. Financial sector is driven largely from foreign investors, hence the flux comes in the form of retained and reinvested earnings mainly. The second largest sector is construction with 16.63 percent, followed by production (15.88), real estate (13.16), transport and telecommunication (9.49) and processing industry (6.61). Other sectors such: electricity, mining, agriculture, trade services, cleaning, collection, advising operations and research, sanitarian activities do not represent a share greater than 4 percent and in total reach the value of 15.34 percent.

Figure 13. Sectoral distribution of FDI in the Republic of Kosovo 2007-2010



Source: Central Bank of Kosovo

Compared with regional countries, for six years period Kosovo exceeds only Macedonia in terms of cumulative FDI net inflows. Albania, Bosnia and Montenegro have reached double value while Serbia appears to be the country attracting mostly foreign investors based on total FDI net inflows. Regardless, a considerable decrease of net inflows observed for Bosnia and Macedonia has led Kosovo to outperform both

countries over the years 2009 and 2010. Worth mentioning is the fact that a small country as Montenegro is, has managed to exceed Macedonia and catch up the level of Albania and Bosnia fast enough. Even though it has experienced a drastic decline in 2010, still Montenegro remains in an enviable position.

Table 13. Foreign direct investment, net inflows and as share of GDP (current US\$)

Variable	Year	Albania	Bosnia and Herzegovina	Kosovo	Macedonia	Montenegro	Serbia
FDI, net inflows	2005	262,479,012.64	607,810,600.81	133,823,510.19	96,999,481.53		2,050,766,877.38
	2006	325,258,316.80	768,276,099.55	369,808,407.38	424,155,269.27		4,968,045,046.53
	2007	662,280,000.00	2,070,789,567.21	603,224,093.07	699,092,642.00	934,442,371.39	3,431,919,716.24
	2008	958,498,924.11	981,785,579.33	536,790,831.64	586,953,718.61	960,423,121.24	2,996,385,200.56
	2009	964,630,946.66	240,108,839.69	402,433,099.07	197,089,613.49	1,527,258,437.65	1,935,601,653.83
	2010	1,109,557,915.39	231,539,217.40	480,916,769.02	207,463,067.12	760,440,979.52	1,340,235,872.92
Total		4,282,705,115.61	4,900,309,903.99	2,526,996,710.37	2,211,753,792.01	4,182,564,909.80	16,722,954,367.46
FDI/GDP	2005	3.13	5.65	3.58	1.62		8.13
	2006	3.56	6.27	9.44	6.47		17.00
	2007	6.19	13.59	12.90	8.57	25.47	8.81
	2008	7.39	5.30	9.51	5.97	21.25	6.27
	2009	8.01	1.41	7.40	2.12	36.88	4.82
	2010	9.41	1.40	8.66	2.26	18.50	3.49
Average		6.28	5.60	8.58	4.50	25.52	8.09

Source: World Bank data

## Incentives regime

The enforced legal framework in Kosovo facilitates the life of foreign and local investors at a great extent. According to IPAK (2011) the updated policies are intended to promote the growth of small and medium sized enterprises SMSE and currently cover the following issue:

*Carrying forward of losses* – Based on corporate income tax law, tax and capital losses can be transferred for up to seven successive periods and are subject of deduction against any income during these years.

*Special Allowances of new assets* – Based on corporate income tax law, in case the taxpayer purchases any new capital goods that is engaged into the economic activity of the taxpayer`s between 1 January 2010 and 31 December 2012, a deduction of 10 percent of the acquisition cost of asset should be allowed in the year at which the asset has been placed into function firstly.

*Avoiding Double Taxation* – Based on corporate income tax law, a resident taxpayer who receives income from any economic activity outside the territory of Kosovo and pays tax on behalf of that income to any state shall be provided a tax credit for the amount paid in the country of origin.

*Customs* – Implemented to promote local production the customs code applies a zero percent rate of customs duty on certain capital goods, raw materials and agricultural production inputs. To date, to the export of goods and services there is no tariff rate applicable.

*Investment guarantees* – Kosovo offers three possibilities for foreign investment guarantee:

1. The Multilateral Investment Guarantee Agency MIGA a member of the World Bank guarantees investments up to the value of 20 million euro,
2. The US Overseas Private Investment Corporation provides political risk insurance for foreigners investing in Kosovo,
3. And other facilities granted for investment and credit guarantees from Austria and Germany.

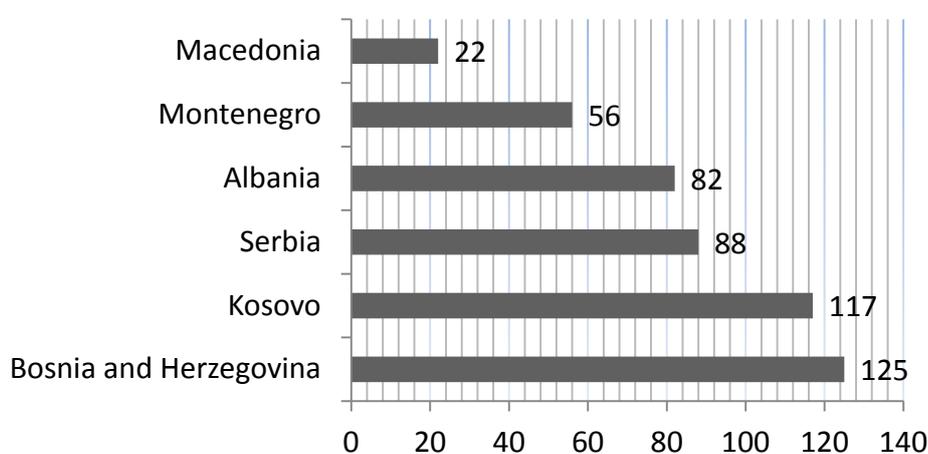
## The climate of doing business in Kosovo

According to World Bank, knowing where the economy is positioned on the ease of doing business worldwide ranking is valuable information for policy makers because with the purpose of improving the regulatory climate for doing business a country has to compare the local system with that of other economies.

Nowadays, doing business indicators have become a useful tool for investors to understand at first sight the circumstances of doing business for a respective country. In highly professional manner with this issue deals the World Bank through its aggregated ranking of around 183 economies. Ten indicators designed to assess regulations pertaining with small to medium sized businesses throughout their operation compile the index which is used as the basis for ranking. The index is subject of: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency indicator.

Fortunately, Kosovo and other countries serving as subject of comparison in this study are included in the broader sample of Doing Business report. While others were involved much earlier, Kosovo joins this area only in 2009 and was one of the reasons that hampered the extraction of any empirical inference regarding the effects of any of the indicators in FDI.

Figure 14. Where Kosovo stands on the ease of doing business (2012)

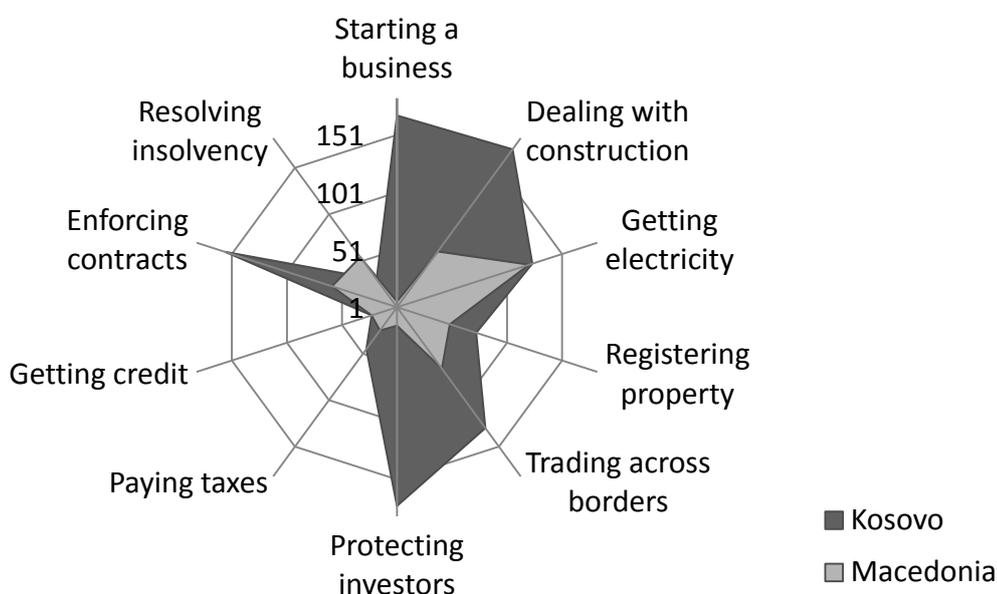


Source: Doing Business database

The overall ranking on the ease of doing business finds Kosovo sitting in place of 117, far from Macedonia and Montenegro that are positioned better among countries of the region. Currently, Kosovo outperforms only Bosnia and Herzegovina without exhibiting any difference compared to the previous year ranking (2011).

Comparing Kosovo with Macedonia as group leader regarding the doing business indicators, gaps are obvious in each domain starting from the dealing with construction to starting a business index. The only sphere at which Kosovo performs slightly better is the issue of resolving insolvency and it is equal to getting credit affair.

Figure 15. Kosovo versus Macedonia on Doing Business topics



Source: Doing Business database

The following table presents the trends of the region for the past two years and clarifies the undesirable position of Kosovo within the group.

Table 14. Summary of Doing Business indicators for Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro and Serbia

	Albania		Bosnia and Herzegovina		Kosovo		Macedonia		Montenegro		Serbia	
	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012
Starting a business	56	61	161	162	165	168	5	6	46	47	81	92
Dealing with construction	176	183	173	163	169	171	147	61	170	173	174	175
Getting electricity	154	154	157	157	120	124	119	121	68	71	77	79
Registering property	126	118	101	100	66	73	67	49	117	108	98	39
Getting credit	21	24	64	67	21	24	45	24	8	8	21	24
Protecting investors	15	16	93	97	172	174	16	17	28	29	74	79
Paying taxes	150	152	108	110	45	46	24	26	125	108	140	143
Trading across borders	76	76	109	108	129	131	70	67	35	34	78	79
Enforcing contracts	88	85	125	125	157	157	65	60	134	133	94	104
Resolving insolvency	62	64	78	80	31	31	55	55	48	52	91	113
Ease of doing business (Rank)	77	82	127	125	117	117	34	22	56	56	92	88
Change in rank	-5		2		0		12		0		4	

Source: Doing Business database

## The tax system

In attempt to incite foreign investors for higher levels of investment, Kosovo has cut the corporate income tax from 20 to 10 percent since 2009. By means of this reform, the country is equated with its regional peers who had intervened in their respective systems long ago. In addition, personal income tax rates are exceptionally low ranging from 0-10 percent. The statutory tax rate for value added tax being applied at the level of 16 percent remains the lowest in region while customs duties on imports stand at 10 percent with no import duties on capital goods and agricultural inputs.

Table 15. Summary of tax burden in Kosovo and other regional countries

	Corporate Income tax	Value Added Tax	Social Security
Albania	10%	20%	16.70%
Bosnia and Herzegovina	10%	17%	10.50%
Kosovo	10%	16%	5.00%
Macedonia	10%	18%	Withheld
Montenegro	9%	17%	5.50%
Serbia	10%	18%	17.90%

*Source:* Doing Business database

The time period starting from 2005 to 2010 counts six reforms applicable on corporate income tax within the region, pointing out the importance of this indicator in striving to raise the competitiveness. Based on empirical findings one would conclude that Montenegro with the lowest rate of corporate income tax is keen to attract more foreign investment as long as other countries do not possess any comparative advantage.

## Degree of corruption control

Empirical analysis has proved that the level of corruption is inversely related with foreign investment. Consequently, the study found of highest necessity the assessment of Kosovo's position with reference to its competitors.

Intended to cure the disease of corruption in Kosovo the Anti Corruption Agency (ACA) has launched its operation since 2006 and conducts its activities in accordance with anti corruption laws based on three main pillars that:

- Ensure the enforcement of laws via proceeding information on corruption to the Public Prosecutor of Kosovo and the drafting of new laws that are required to meet the legal framework of this area,
- Prevent or eliminate the corruption source through asset declaration of senior officials, prevention of conflicts of interest and registration of gifts in the central bodies,
- And raise the awareness of public administration and citizens on the functioning of anti corruption laws.

Though, the degree of corruption in Kosovo as in any other transition economy is perceived to be relatively high in general.

Table 16. Control of corruption index and ranking of countries

	Albania	Bosnia and Herzegovina	Kosovo	Macedonia	Montenegro	Serbia
2005	-0.752 25	-0.189 51	-0.609 34	-0.437 40	0.025 57	-0.377 44
2006	-0.787 22	-0.278 49	-0.535 35	-0.363 44	-0.427 40	-0.280 48
2007	-0.679 28	-0.384 42	-0.718 25	-0.344 47	-0.299 48	-0.352 45
2008	-0.506 37	-0.363 45	-0.621 32	-0.196 52	-0.299 49	-0.268 50
2009	-0.439 38	-0.373 44	-0.566 33	-0.124 56	-0.291 50	-0.206 52
2010	-0.429 41	-0.318 48	-0.640 32	-0.059 56	-0.334 47	-0.213 52

Source: World Bank data

The aggregate indicators of governance among the set of six indicators include the control of corruption index that reveals the extent at which public power is put into effect for private gain. The indicator ranges from -2.5 to 2.5 and the higher it is the stronger the county's performance is likely to be.

Results of comparative analysis provide evidence that Kosovo has stagnated in the endeavour to improve its worldwide image in terms of corruption. The latest estimation rank it as 32<sup>nd</sup> country, quite forward Macedonia and Serbia that have managed to reduce the corruption level at a greater extent. Impressive is the performance of Albania that managed to improve its position extremely well, for the four year period it has climbed the 41<sup>nd</sup> place in other words it made nineteen steps since 2006.

Accordingly, it is comprehensible that Kosovo has failed to control the level of corruption and this issue is evaluated to be one of the main concerns for Kosovo's government and ACA for upcoming years. This level of corruption leads only towards the irritation of foreign investors that are reckoned as the saviors of economic recovery.

## The role and importance of IPAK

As most often, IPAK is a Government Institution whose mission is to support foreign investment in Kosovo. Apart from foreign investor attraction the Agency is in charge to promote exports also. Shored up by the Ministry of Trade and Industry of Kosovo it is financially supported from Austrian Development Agency (ADA) within the project `Foreign Investment Promotion in Kosovo`. Since 2006, the Economic Initiative for Kosovo (EIKS) headquartered in Vienna, represents IPAK in the German speaking region connoting Austria, Germany and Switzerland.

The main assistance of the Agency towards foreign investors is:

- To provide comprehensive advice and support from professionals who combine their knowledge regarding local circumstances and the understanding of international business.
- To provide help in identifying the appropriate property options to host the operation of foreign firms in Kosovo,
- To provide help in obtaining all required approvals from National and Municipal Authorities in Kosovo, and speed up the process of business starting,
- In terms of cooperation, the Agency provides introductory information to potentially partners for collaboration,
- And the most important, the Agency strictly ensures the commercial confidentiality of all interested parties.

According to IPAK, for companies interested to invest in a country characterized with very low costs and an easy access to EU, Central European and Balkan markets, Kosovo is considered as a highly attractive alternative. The Agency has listed top ten reasons to invest in Kosovo as:

*A good strategic location* - because it is located in the centre of the Balkans, Kosovo is found to be an ideal shore from which the distribution of products and services to the EU, Central and Eastern European markets would not pose any problem. Great connections that link Kosovo with the most important business

centres of Europe assist in completing and facilitating the conditions of doing business. The international airport located in the capital city of Kosovo is one of the most frequented in the region. The terrestrial infrastructure including road and rail networks have improved at a large extent, covering the entire territory of Kosovo the rail network is linked with the international network through its connections to the north and south of the country.

*Free Access to a 520 million consumer market* – having a liberal free market trade regime, Kosovo based on the EU Preference regime benefits from the duty-free access to the EU market. This agreement has abolished many quantitative and qualitative restrictions that remain in force for a considerably small number of goods only. Supplementary, the country has entered a free trade agreement with the Central European countries under CEFTA that supplies duty-free access to a market of 28 million consumers. All together these accords will provide Kosovo an access to more than 520 million consumers.

*Lowest costs within the euro currency zone* - one of the rare countries that although are not members of the Euro-zone but still introduced as its official currency the Euro, Kosovo lies also among countries with the lowest cost in the region. The Euro adoption has lowered transaction costs, contributed to a manageable rate of inflation that strongly enhanced the promotion of trade and investment due to reduction of market risk.

*Youngest population in Europe* – with the 70% of total population being under the age 35 and 50% below 25, the country is considered to be the one with the youngest population in Europe. The multi-ethnic spirit of the society and the high rate of literacy in foreign languages are estimated to characterize this young population that mainly speaks Albanian and Serbian languages but due to the extremely large flux of international staff English is qualified as the third official language.

*A readily available and motivated workforce* – the strong work ethic, the abundant labour supply with low costs compose a highly productive and cost effective workforce. Even though hallowed, due to harsh competition in the labour market and a remarkable job shortage, Kosovo suffers from an unceasingly high

unemployment rate. Therefore, the labour market supplies not only basic semi-skilled output, but also an excessive part of highly educated labour.

*Very low taxes* – designed with the purpose to attract foreign investors, Kosovo has decreased its corporate income tax from 20 to 10 percent and consequently it is equated with its regional competitors. Personal income tax rates are progressive ranging from 0 to 10 percent and the standard VAT rate is 16 percent.

*A Government highly supportive of foreign direct investment* – after the evidence of a very high rate of unemployment the attraction of foreign investors is one of the top priorities of the Government. This task is assigned to IPAK through service delivery and timely response to probable foreign investors in Kosovo. Assisting the process of location decision making, the Agency works with National and Local Governmental authorities where necessary.

*Modern EU-compatible legislative system* – Kosovo has adopted also a modern and EU-compatible legal framework including the legislation for foreign investment that preserves the same legal position for both domestic and foreign investments.

*Sound banking system* – operating as two-tier banking system it is comprised by Central Bank of Kosovo and numerous commercial banks. The presence of foreign banks has reached the satisfactory level making banking sector of Kosovo to be recognized as one that records positive and competitive performance across the most important financial indicators such are: return on equity ratio, capital to equity ratio, liquidity ratio and loan portfolio versus GDP.

From all its activities, particular importance takes the promotion of exports which is intended to alleviate the way of finding partners for foreign investors in Kosovo and promote the local production in foreign markets.

According to the agency this mission is performed through:

- The identification of local partners by organizing meetings, serving the database for exports and sharing the sectoral analysis and studies that help exporters to reach international markets.
- Giving a hand in promoting local products in international fairs,

- Granting development programs that improve the competitiveness of local companies.

Moreover, IPAK is a member of the World Association of Investment Promotion Agencies whose data show that countries of region possess an active agency namely that even at this point a strong competition is taking place between the Balkan countries.

## Conclusion

As long as there is no such study to date, the core idea of this study was to develop an empirical framework that estimates determinants of FDI for the Republic of Kosovo particularly. However, the lack of data led to panel analysis covering 27 transition and post-transition economies for the period of 2003-2010. This study investigates empirically the true effect of seven variables into foreign flows and finds the groupwise weighted least squares model to be the most appropriate.

As the breakdown period (2008-2010) was included in the data set used to modelling the behaviour of FDI, both Chow test and the time dummies technique suggest the presence of structural break meaning that the fashion of FDI is determined differently depending on the economic propensity. Therefore, we found more convenient to interpret results as a contrast of two episodes but the insufficient number of observations after data set separation was the cause of miscalculations for the second scenario (post break period).

Ultimately, empirical results show that FDI is positively related with one year lagged effect of real GDP growth, trade openness, labour force, low level of wages proxied by remittances, real interest rate and the low level of corruption. Besides, the corporate income tax is found to be significant and inversely related with foreign flows meaning that countries with lower corporate tax burden are tended to be shores of foreign investors. In addition the low level of corruption is found to attract foreign flows.

Then, the study takes the advantage of empirical findings and conducts a comparative analysis between Kosovo and regional countries such: Albania, Bosnia and Herzegovina, Macedonia, Montenegro and Serbia.

The analysis considering the growth rate of real GDP shows that Kosovo has the most stable macroeconomic environment in the region. The growth rate appears to be solid and comparatively more sustainable but it is continuously confronted by the high deficit of trade balance and high rate of unemployment which can be reduced only and only by increasing the level of foreign investment that create new

jobs in turn. As long as trade openness is empirically found as key determinant of the behaviour of FDI, one of the main obstacles that have abolished efforts for foreign investment attraction is considered therefore the trade blockade of Kosovar products by Serbia and Bosnia and Herzegovina.

Appart, surrounded with all these difficulties for the moment Kosovo is distinguished for its stable monetary policy characterized with the lowest rate of inflation in region. On the other hand, the highest real interest rate remains the main needle that has diminished the rate of return for private sector projects. Given that local businesses base their investment decision mostly on home financing sources, they may lag behind their foreign competitors who have wider access concerning long term financing. And, if high rates of interest are positively related with FDI as empirical evidence suggests this absolutely does not mean that Kosovo is doing well, rather it must intervene at this point because local firms are in need for incentives as well.

Further analyses have uncovered the unenviable position of Kosovo regarding the doing business climate. To reinforce its position the study highlights the need for improvement in five areas as: starting a business, protecting investors, trading across borders, enforcing contracts and dealing with construction indicator.

In addition, it is assessed that Kosovo has failed to control the level of corruption and this issue is evaluated to be one of the main concerns for the government and ACA for upcoming years. The highest level of corruption in region leads only towards the irritation of foreign investors that are reckoned as the saviors of economic recovery.

As for the tax regime, Kosovo is qualified to be fairly competitive but unable to benefit from its comparative advantages even in the future, this due to the above mentioned drawbacks.

And finally, the study finds an increasing need for comprehensive and up-to-date data concerning each economic indicator that can be used for either empirical or any other type of analysis that in turn ensure the accurate identification of Kosovo's economic activities proficient for its further development.

## Appendix

Table 1. Correlation Matrix

FDI	GDP	TRADE	LabF	REM	RIR	INF	CIT	CoC	
1.0000	0.0553	0.1415	0.0227	0.0400	-0.0156	0.0711	-0.0650	0.0085	FDI
	1.0000	0.0489	0.1496	0.0505	-0.2178	0.3302	0.2306	-0.2559	GDP
		1.0000	0.0357	-0.1475	-0.2621	0.0095	0.0950	0.3808	TRADE
			1.0000	-0.0405	0.0153	0.0637	0.2257	-0.0703	LabF
				1.0000	0.2049	0.1723	-0.2534	-0.4684	REM
					1.0000	-0.6185	-0.1623	-0.1614	RIR
						1.0000	0.2596	-0.4231	INF
							1.0000	-0.0552	CIT
								1.0000	CoC

Table 2. Collinearity test

Variable	VIF
GDP_1	1.192
TRADE	1.257
LabF	1.081
REM	1.581
RIR	2.999
INF	3.675
CIT	1.294
CoC	2.378

Table 3. Tests for structural break

<b>F-test</b>
F value = 5.2530
F(6, 175): p-value = 5.32452e-005
<b>Chow test</b>
F value = 5.9193
F(6, 146): p-value = 1.45557e-006

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