

UNIVERSITY OF SARAJEVO  
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UNIVERSITY OF LJUBLJANA  
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MASTER'S THESIS

**THE IMPACT OF REGULATORY QUALITY ON FOREIGN  
DIRECT INVESTMENT FLOWS IN SOUTH EAST EUROPEAN  
COUNTRIES**

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## **LIST OF ABBREVIATIONS**

FDI - Foreign Direct Investment
SEE - Southeast Europe
CIS - Commonwealth of Independent States
CEE - Central and Eastern Europe
WIIW - Vienna Institute for International Economic Studies
GDP - Gross Domestic Product
EU - European Union
EBRD - European Bank for Research and Development
NIE - New Institutional Economics
BRICS - Brazil, Russia, India, China and South Africa
FE - fixed effects
PCSEs - panel-corrected standard error

## **INTRODUCTION**

The globalization of the world economy has brought in about a huge increase in the volume of foreign direct investments (hereinafter: FDI) in transition countries and as a result, these countries are becoming more accessible and oriented to these kinds of international capital flows. From the beginning of the transition process in Eastern Europe, FDI has been characterized as a key factor in the restructuring process.

FDI represent a major source for capital-intensive projects from multinational companies worldwide. They reflect not the only cross-border movement of resources; but also the transfer of technology and expertise, thus contributing to the growth of competition, jobs, and foreign trade, and as a result to the economic growth and development of the local economy, which is the driving behind the globalization of the global economy (Derado, 2013).

In literature, there are different interpretations and definitions of FDI developed by many authors. But the definition given by the International Monetary Fund (1993) and approved by the Organization for Economic Co-operation and Development (1996) is mostly used: “Foreign direct investments are a category of international investment that represents the phenomenon when a foreign investor or parent company located in one country gains long-term benefits of the company which is located in another country.” A similar attitude in defining the concept of foreign direct investment have Dunning and Lundan (2008), who believe that in addition to the transfer of financial capital, foreign direct investments contribute to the transfer of management skills in management, acquiring new knowledge, the use of advanced technologies in production, adoption of new marketing knowledge and management skills.

According to Anwar and Nyugen (2010), FDI has led to impressive economic growth in numerous developing countries. Generally speaking, FDI don't only contribute to the increase of capital, but also with the appropriate policies of host countries can facilitate the transfer of technology. The transfer of technology contributes to the formation of human capital which can additionally facilitate economic growth.

Furthermore, Kukaj and Ahmeti (2016) stated that the role of FDI is considered as one of the most important features which influences economic growth. Through the past quarter-century, a remarkable growth of FDI flow has been recorded all over the world since many countries recognized FDI as an important factor for the development of their economic strategies. They stated that FDI can influence the economic growth of the host country in two ways. They contribute to the increase of domestic capital and they lead to the improvement of efficiency through the exchange of new technologies, new

skills, and innovations, and best experiences. Also, Vig (2018) added that FDI can encourage the expansion and modernization of the economy. FDI can provide new technologies and necessary knowledge for the modernization of specific industry branches and contribute to the training of human resources and to the improvement of the company's management.

Besides the fact that FDI represent one of the ways to stimulate economic development, they also accelerate reforms and necessary restructuring of the economy in the state. In addition to the entrance of fresh capital into the country, FDI have many other positive effects, such as better corporate governance, new knowledge, and values of developed economies, new technologies and competitive products, access to key global markets, development of the industry by connecting companies and technology transfer, developing economies of scale and production efficiency. According to the Vidas-Bujanja (1998), the importance of the FDI results that governments of transition countries seek to attract FDI as much as possible. His opinion is that one of the strategic goals of any transition economy represents attracting FDI. These types of investments are considered to be an essential source of economic development, modernization, production growth, exports, employment, and profit. FDI have a huge economic and political importance. Based on the level of FDI it can be concluded that a particular country has certain performances and economic future and that investing in that type of country can be profitable. The capital of foreign investors needs to be focused on areas where the host country has a certain competitive advantage increasing the overall level of productivity, economic growth and creating opportunities for the competitiveness of export goods in the world market. These investments initiate the development of new economic activities which strive to give a greater contribution to economic development, reinforce competitiveness in the global market and improve the condition of the state.

To explain the strategies of multinational companies in the international market and determinants of FDI, John Dunning developed the eclectic paradigm (hereinafter: OLI) theory. The OLI theory is considered as a simple theory, but also it represents a viewpoint that indicates that the geographic position and industrial structure of foreign production by multinational companies depend on the interaction of three sub paradigms: ownership advantage, location advantage, and internalization advantage. This means that multinational companies to be competitive in foreign markets must possess these three advantages in comparison to local companies. The impact of the OLI theory is double. First, it explains why companies invest in foreign markets and their motives for FDI, and second refers to the mode of how multinational companies enter the foreign market (Dunning, 1977).

To be able to operate successfully abroad, multinational companies must have a specific advantage of possession compared to other companies in the same market that will reduce additional costs that arise due to the elements of foreign. These advantages are manifested in owning a particular production process, material resources, managerial talent, blueprint, application of new technologies, patents, trademarks, and many other assets. The possession of the advantage of ownership for a multinational company is not enough for a successful business in a foreign country. Since the operations in foreign markets are connected with higher production costs and greater exposure to risks, multinational companies together with the advantage of ownership must have additional arguments for conducting business in these markets. Therefore, the advantage of location represents determining factor in deciding which country will be chosen for FDI by multinational companies. The existence of strong location advantages is very important since these advantages reduce multinational company's production expenses in that country. According to Twomey (2000), it refers to the existence of raw materials, cheap workforce, land, special taxes, etc. Besides the advantages of ownership and the advantages of location which explain why and where companies invest when expanding abroad, the advantage of internationalization describes how companies enter the international market. The advantage of internationalization seeks to give answers on how multinational companies will utilize its ownership advantages, will it be done through export, licensing, or FDI (Dunning, 2000).

In the extensive empirical literature, we can recognize two groups of FDI determinants: traditional and institutional. These two groups of determinants of FDI influence the flow level of FDI in different ways. Given that the purpose of this master thesis is to examine the impact of regulatory quality on the attractiveness of FDI in South East European countries (hereinafter: SEE countries), attention will be given to the institutional determinants of FDI, but also traditional determinants have to be mentioned.

Not all researchers share an opinion that institutional quality is quite an important factor in attracting FDI. Jensen (2003) conducted research focusing on 114 developing countries all over the world and using panel regression for years from 1970 to 1997 and found that expropriation, corruption level, bureaucratic framework, and rule of law do not affect the inflow of FDI while trade openness and economic growth represent important factors influencing FDI inflows. Furthermore, Petrović-Ranđelović, Janković-Milić and Kostadinović (2017) analysed the impact of market size, market growth, trade openness and population size on the level of FDI inflow of the Western Balkan countries. Using multiple regression analysis, they managed to prove that market size, market growth and size of the population have a significant impact on FDI inflow, while they didn't find a positive correlation between trade openness and FDI inflow. In addition, many authors stressed the importance of economic factors presence such as market size and resource endowments as one of the main motivators for abroad

investments. They stated that multinational companies are attracted to locations where the abundance of natural resources is presented and to the locations where they can exploit specific advantages of their firms.

In the literature, there are various theoretical perceptions of the interpretation of institutions and their connection with organizations (Buchanan, 1991; North, 1990;). In general, institutions are recognized as frameworks or rules of the game, while on the other hand organizations are characterized as players who play the game (North, 1990).

The general opinion that dominates among scientists is that institutions were developed as a response to market imperfections, and as such, their role is to increase efficiency related to economic transactions. Theoretical conceptualization of institutions is largely oriented to the attitude that institutions are perceived as frameworks or rules of play, which define and limit the activities of social organizations of various kinds. This theory suggests that there is a clear difference between institutions and organizations. Vanberg (1992) considered that institutions create a set of rules that define the framework within the organizations work.

First, who stressed the importance of institutions in attracting FDI was North (1990). He found out that good institutions raise the level of FDI and economic growth in the state. Other scholars who were among the first scholars who investigated the influence of institutions on FDI flow were Wheeler and Moody (1992). Analysing 13 risk factors including quality of a legal system, corruption, bureaucracy and political instability, they didn't find out that institutional quality had an impact where US companies located their foreign affiliates. However, their study also included factors as inequality level and environment of expatriates which are not related to the institutional quality.

There are many authors who in their research papers have found a positive correlation between institutional determinants and level of FDI inflows. Kersan-Skabić (2013) revealed that besides traditional determinants many other institutional factors have a representative impact on FDI inflows. It is in her opinion that not all SEE countries are equally effective in bringing in foreign capital which depends largely on each country's unique institutional characteristics.

Markusen and Venables (1998) in their study revealed that locations determinants may play important factors in attracting FDI and include traditional factors such as the availability of natural resources, market size, macroeconomic environment but institutional factors (property rights, FDI incentives, trade agreements, taxes, etc.) must not be forgotten.



According to Globerman and Shapiro (2002), institutional frameworks are crucial for the functioning of the market. In particular, structural failures, frequent changes in legislation and inefficient public administration can lead to poor inflows or the absence of FDI in particular country.

Meyer's (2001b) opinion is that under-developed institutions raise the costs of founding the companies that are wholly owned by multinational companies in transitional economies. Meyer finds that the international market is increasingly marked by an institutional dimension where this dimension is characterized as the key local advantage of the host country.

The positive correlation between institutional determinants and FDI was also found by Benassy-Quere, Coupet and Mayer (2007). By analysing institutional factors such as bureaucracy, corruption, information, the banking sector and legal institutions, they examined the quality of institutions and found that differences in institutional quality in the home and host countries have an impact on FDI flows.

Mudambi and Navarra (2002) stated that international business activity is largely supported by the reality that institutions are one of the main factors in the international market, whose features determine the attractiveness of the host country. The expectations are that multinational enterprises will invest more in countries where rules are regulated, where justice and management systems are effective, as well as where the regulatory framework is clearly defined that reduces uncertainty in the exchange of economic goods. Foreign companies have to adapt to the conditions of the host country, so a weak institutional framework may affect not only the costs of a foreign company but also the strategic decisions on how these companies will expand to foreign markets. In addition, Dunning (2004) added that role and institutional quality represent very important location's factor for FDI. The institutions influence the cost of business activities for investors in a host country, which can be done by insufficient protection of property rights, cumbersome bureaucracy, corruption, insufficient judiciary and so on. It can be said that inefficient and poor institutions increase operating costs which consequences that countries with a bad institutional framework are not attractive to foreign investors.

Buchanan, Le, and Rishi (2012) examined the effect of institutional quality on the level of FDI creating a panel data analysis of 164 countries from 1996 to 2006. They found that the inflow of FDI is influenced significantly by good institutional quality.

To a large degree, transitional countries have faced the need to change their economic and political systems, switching from a centrally planned economic environment to a free economy and the distribution of capital. Conventional economic wisdom suggested

that the former centrally planned economies should establish institutions that support free-market transactions and good functioning markets as quickly as possible. The importance of an institutional environment which strives for the rapid development of the market has been placed high on the transition reform program. Initial institutional development in the context of the transition economy represented the initial institutional progress in the context of the transitional economy, including the establishment of appropriate incentives through macroeconomic stability, price liberalization, denationalization and privatization policies, and institutions that facilitate successful change and growth of the financial sector. During the 90s, the transition countries positively oriented toward the FDI to exploit the external benefits that have dominated the world market. Growth in production in Western Europe in the early 90s increased demand on the world market for raw materials, intermediate products and certain investment goods at the disposal of the countries of Eastern Europe. Exports of these countries have experienced an expansion with a positive impact on the economic growth of these countries.

The state and institutions of transition countries represent an important factor in maintaining economic stability and constituting a favourable market climate in attracting FDI. By making the promotion of potential investment opportunities and abandoning restrictive policy towards the inflow of foreign private capital and providing investments incentives to foreign investors, the government taking key steps in attracting FDI. Promotion of potential business opportunities includes a set of activities such as informing potential foreign investors about investment opportunities, constituting the country's image as an attractive location for investments, providing a variety of services that are directly or indirectly related to the implementation. Since foreign investments represent a specific type of economic transaction that requires clearly defining the rights and responsibilities of both entities, it is important to provide suitable legislation and appropriate regulations that will allow the foreign investor in terms of business survival in another country to feel legally safe and secure.

Research conducted by Hornberger, Battat and Kusek (2011) showed that institutional and regulatory quality is significantly biased with the inflows of FDI. The results of the research showed that investment climate i.e. institutional and regulatory quality is very important and has a major impact on investors where to invest. For nearly 30,000 foreign direct investors who were involved in research, investment climate was the third most important factor. The results showed that improvements in the business climate in transition countries have a positive effect on the inflow of FDI.

Therefore, the principal aim of this master thesis is to analyse and investigate the impact of regulatory quality on FDI in SEE transitional countries and to fill a gap in the current literature on the main determinants in transition countries by providing econometric

analysis of potential institutional factors that influence the inflows of FDI in SEE countries. This would have some big repercussions for potential policymakers in proposing ways to reinvigorate foreign investment in the SEE area.

Although many researchers have recognized the importance and impact of quality of regulation on the inflow of FDI, they don't pay attention to much on the regulatory determinants, just a few authors dealt with the institutional concept of regulatory determinants and their effects on attracting FDI. The available literature works mostly stress the role of the market size, economic reforms and labour costs as the main factors influencing the inflow of FDI while the role of institutions have fallen into another plan. The focal point of this master thesis will be to examine the role of institutional determinants on the inflow of foreign direct investments in transition countries and contributing to filling a gap in the existing literature.

The purpose of the thesis is to analyse the relationship between FDI and institutional determinants with special emphasis on regulatory quality, as a determinant of FDI inflow in transition countries. The empirical research conducted in this study explores whether the regulatory efficiency of transitional economies has a major effect on the level of inflows of FDI into SEE countries.

The hypothesis of the thesis is the following:

H1: The regulatory quality has a positive and significant effect on the FDI inflow in the SEE transition countries.

The objectives of the thesis are the following:

- to provide a literature review of the FDI and impact of institutional determinants on FDI inflow,
- to analyse the impact of regulatory quality on FDI in SEE countries,
- to make recommendations to the policymakers on how to improve the business environment to attract FDI.

The research will be based on a sample of seven SEE countries (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania and Serbia) in the period from 2000 to 2015. This thesis aims to explain if there is a relationship between the quality of regulation and FDI in the observed countries. The variable of interest in this research will be regulatory quality. By implementing market-friendly policies such as price caps, government interference, and free movement of capital, regulatory quality boosts inward FDI. In addition regulatory quality captures the capacity of the government to develop and enforce sound policies and regulations that foster economic development. An econometric model will be developed that combines the traditional determinants

(market size, labour costs, distance, macroeconomic stability, openness, etc.) and specific institutional factors. The variable of interest will be measured using the indicators published by the World Bank. Data for independent variables will be gathered from the base published by Vienna Institute for International Economic Studies (hereinafter: WIIW).

The thesis is structured in the following order. In the first chapter theoretical concept of FDI is provided. The definition of FDI and explanation of different concepts of FDI will be given. Also, this chapter explains current global FDI trends and also current FDI trends in seven observed countries of the SEE region. In the second chapter, the role of institutions will be emphasized and their relationship with FDI will be explained. The third chapter refers to the theoretical background of the investigation. OLI framework developed by Dunning will be explained, as well as the institutional theory. The fourth chapter explains the traditional and institutional determinants used in econometric analysis and how they influence the inflow of FDI. The fifth section is divided into four subsections. Subsection 5.1 explains the model and methodology used to prove the hypothesis of the master thesis. Subsection 5.2 presents the overview of variables used in analysis and their sources, in subsection 5.3 model specification is explained while subsection 5.4 interprets the results of research. Finally, in the end, all results and observations from this master thesis will be given and explained, also contributed to the knowledge and limitations of research will be included. This part of the master thesis also includes some recommendations for the improvement of the regulatory quality.

## **1 LITERATURE REVIEW**

### **1.1 The definition of FDI**

In literature, there are different interpretations and definitions of FDI developed by many authors. But the definition given by the International Monetary Fund (1993) and approved by the OECD (1996) is mostly used: “Foreign direct investments are a category of international investment that reflects phenomenon when a resident located in one country (foreign direct investor or parent company) achieves lasting benefits of the company which is a resident of another country.”

A similar attitude in defining the concept of FDI have Dunning and Lundan (2008), who believe that in addition to the transfer of financial capital, FDI contribute to the transfer of management skills in management, acquiring new knowledge, the use of advanced technologies in production, adoption of new marketing knowledge and management skills. According to Ayanwale (2007), FDI can be defined as an investment with the aim to achieve lasting management interest to become the owner of 10% of voting shares or more of the company in the host country. These investments may be

greenfield investments, merger and acquisitions. Ownership of at least 10% of voting shares is a criterion for the existence of a direct investment relationship, while ownership of less than 10% of voting shares is treated as portfolio investment.

Lipsey (2002) defined FDI by using macro and micro concepts. In the first concept, he described FDI as a form of capital flow across national borders from home countries to host countries, while the second one explains the main motives for investment in certain areas. The micro concept is composed of a set of economic activities which are carried out in a host country but controlled by an enterprise in the home country. These activities are employment, production, human capital, etc.

## **1.2 Types of FDI: Horizontal, Vertical and Knowledge-Capital model**

There are three fundamental kinds of FDI: horizontal, vertical and knowledge-capital model. The division of these types is dependable by the function of FDI at its home company's global strategy.

Horizontal FDI represents business activity conducted by multinational companies to produce in host countries in multiple facilities similar or almost the same products as they produce in home countries. This type of FDI is also called market-seeking FDI and it is driven for local customers. There are many reasons why multinational companies undertake this type of investment. Some of them are: cheaper production in the host country than in the home country, there is no high transportation costs from home to the host country, no trade barriers and better access to the local market because when a company is located in the host country it has better information about customers' needs at a local market. When multinational companies undertake this type of investment they build a new factory in the host country, instead of exporting to a particular host country. They are driven by the fact that installing a new factory abroad is cheaper than transportation costs and customs duties. Forte (2004) and Markusen and Venables (1998, 2000) stressed out that horizontal type of FDI occur between countries with similar market size, a similar level of technological development and factor endowments where there were no comparative advantages for trade.

Vertical FDI refers to business activity where a multinational company invests in production in a host country which depends on a large market, transportation costs and factor endowments. This type of FDI is also known as resource-seeking FDI. The goal of an established production system abroad is to serve the needs of home country market. Multinational companies divide the production process geographically and locate each production's particle in the country where it can be produced at the lowest possible cost. Dividing the manufacturing process into different locations is only profitable if the expense of fragmentation is smaller than the cost of saving. Such

expenses are related to transport, customs duties and bureaucracy. In countries with lower incomes and an abundance of unqualified employees, multinational corporations aim to manufacture at a low cost.

The Knowledge-Capital model presents the connection between horizontal and vertical foreign direct investments and highlights that no matter which type of FDI is used by multinational companies the know-how is geographically easily transferable to multiple facilities abroad to support the production process. Determinants of horizontal foreign direct investments are market size, factor endowment and transportation cost while vertical foreign direct investments are based on differences in the factor endowments.

### **1.3 Forms of FDI**

When FDI are classified according to how they are made, the common classification of FDI is the following: greenfield investments, cross-border mergers and acquisitions and joint ventures.

Greenfield investments refer to the investments of the multinational company into a foreign market by establishing completely new property and setting up all necessary infrastructure starting from zero for the successful operation of the business. This form of FDI is popular in markets with low competition and in developing markets due to expected economic growth. These markets may be characterized as uncertain due to credit ratings, unstable political situation or military intervention so this kind of investment can be considered risky. There are also additional risks that can be caused by a poor corporate governance system, liquidity constraints and currency risk. The host country has benefit from greenfield investments due to making and opening new employments for residential individuals and decreasing the percentage of unemployment in the state. The main motives for choosing greenfield investments over mergers and acquisitions and joint ventures are low transaction costs and greater efficiency in comparison to two other forms. Greenfield investments lead to a better economic situation in the host country, so investments of this type are welcomed by host governments.

Cross-Border Mergers and Acquisitions have been used for a long period by multinational companies as an entry mode for expansion into foreign markets. A multinational company merges or acquires an established company in another country taking over full managerial control over that company accomplishing 100% of ownership. Compared to greenfield investments and joint ventures, mergers and acquisitions are cheaper than greenfield investments and present a much faster entry mode into foreign markets and because of that, they are the most chosen entry mode when time plays a significant role. According to Shimizu, Hitt, Vaidyanath and Pisano

(2004), cross-border mergers and acquisitions enable a company to access new markets, gain new knowledge and acquire new capabilities. On the other side, Brouthers and Dikova (2010) stated that mergers and acquisitions are not always the best possible entry mode when expanding into international markets. They claimed that acquisitions are always in danger of cultural clashes between parent and acquired entities which may obstruct the flow of knowledge between these two sides.

Joint ventures illustrate the mode of entry into the international market where, by partial contributions of two-parent companies, two entities create a separate legal organizational body in which the central command of at least one entity is located outside the host country. Both of these businesses are economically and legally free from each other. Elango and Sambharya (2004) described joint ventures as a partnership where two or more companies jointly own the company. In addition to business risk-sharing, companies involved in joint ventures often share strengths, particularly local market awareness of partners located in the host country. Kirby and Kaiser (2003) emphasized that joint ventures can be used as a tool to access capital implanted in other organizations and as a tool to acquire local management skills and links to ensure rapid expansion into international markets. Investment of this type can help a foreign company to gain legitimacy because a local partner can help in creating business strategy and activities that obey local norms, values and expectations. As the previous entry modes, joint ventures have some disadvantages as well. Working with a partner can make activities a little complicated because multiple viewpoints have to be taken into consideration when developing business policies and strategies. Also, comparing to mergers and acquisitions where an investor has access to all resources, in joint ventures investor can only use resources offered by a local partner.

#### **1.4 The motives of home country for FDI**

Dunning (1993) and Globerman and Shapiro (1999) were investigating why multinational enterprises investing in specific locations. They concluded that FDI are very attractive to multinational enterprises due to strong economic reasons and opportunities that are dominating in the foreign markets such as market size and its varieties, skilled workforce, abundance of natural resources, macroeconomic and political environment. Regardless of the success of multinational enterprises on the domestic market, before they decide to invest in specific locations they need to have specific advantages comparing to the companies in the host country. Those advantages are reflected in advanced technology, trademarks, patents, strong marketing and management skills, etc. In table 1 the main motives of the home country for FDI are displayed.

The main reasons why companies invest abroad and become multinational can be explained by using OLI framework developed by John Dunning, which explains why and how companies decide to invest abroad and in which particular locations they will invest. He claimed that a company's decision about investing abroad is determined by ownership, location and internationalization dimensions.

Table 1. *The main motives of home country for FDI*

Type of FDI	Factors influencing location of investment
Resource seeking	The presence of different natural resources and raw materials at low cost, as well as human resources, infrastructural development like communication and transport.
Market seeking	Size and growth of domestic and regional markets, availability low cost of labour and low production costs, avoidance of transportation and trade costs or trade barriers, infrastructure quality, institutional competence, competition with main competitors in their own markets.
Efficiency seeking	Reduction of production costs; availability of skilled workforce; resource-saving and improved efficiency, location of production near customers, utilization of benefits of economies of scale and scope.
Strategic asset-seeking	Acquiring assets in a foreign firm that promote long term objectives, availability of advanced technology and management expertise, joining with local firms to secure better contacts with local government, access to different cultures, institutions and systems.

*Source: Cleeve (2008).*

### 1.5 The effects of FDI on the host country

According to OECD (2002), the host country economic growth can be affected by FDI in many ways. There are various mechanisms by which FDI can affect the host country's economy. These include the transfer of new technologies, the development of human capital, the convergence of global markets and the growth in competition. These processes can have positive and negative effects on the host countries' economic results.



According to Findlay (1978), FDI represent one of the ways how economic performance in host countries can be improved by the introduction and import of new more advanced technologies developed by multinational firms. Borensztein, Gregorio and Lee (1998) stated that multinational firms are always considered as more technologically developed since they spend a big portion of funds on research and development and their habitation in numerous parts of the world is of great importance to their technological development. According to Berthélemy and Démurger (2000), the introduction of new technologies leads to a reduction of research and development costs of local firms and in this way these firms become more competitive. The transfer of technologies by multinational firms to firms in host countries improves the firms' productivity which in turn influences the growth of Gross Domestic Product (hereinafter: GDP).

However, the transfer of technology can also have negative effects on the firm's productivity. Sen (1998) stated that multinational firms may negatively react to host country research and development trying to maintain technological supremacy compared to local firms because multinational firms in most cases only transfer inappropriate technologies to host countries.

Borensztein, Gregorio and Lee (1998) argued that when multinational firm transfers new technology into the host country, there is need for a skilled workforce that new technology can be used appropriately. Host countries often have a lack of skilled workforce, which leads that multinational firms provide necessary training to their workers and in that way increase capacities in host countries. Moreover, Hanson (2001) stated that training provided by multinational firms affects the whole economy of the country, as local firms will employ this working force because they need a skilled workforce and many other workers will use the knowledge gathered by multinationals to establish their own companies and transmit knowledge to employees in particular companies.

A second tool over which FDI can influence the host country's economic performance is the creation of a labour force. Zhang (2001) stated that FDI can foster the economic growth of host countries by transferring new production and management methods and highly skilled workers. The improvement of the labour force in the host country leads to better economic performance. The development of the labour force can be done by informal training that occur while workers observe new operations developed by multinational colleagues and through formal training (Loungani and Razin, 2001; Alfaro, Chanda, Kalemli-Ozcan and Sayek, 2004).

The negative consequence regards the labour force is that usage of advanced technology by multinational firms shows firms in a host country that they don't need to have a high

number of workers to operate successfully. This can lead that local firms reduce their workforce, which increase the unemployment level in the state (OECD, 2002).

The economy of the host country can be integrated into the global economy in a way that FDI contribute to the inflow of foreign capital in host countries (OECD, 2002). Barry (2000) argued that country's integration into the global economy lead to greater trade openness and as a consequence country generates more profit thus enhancing its economic growth. Another way how host countries can be integrated into the global market is by copying and acquiring knowledge and new techniques by multinational companies. Multinational companies have already passed through the process of internationalization and they have better knowledge about international trade. Blomström and Kokko (1998) claimed that the main competitive advantages of multinational companies compared to local firms are manifested in marketing expertise, formation of cooperation and establishment and development of international lobbies.

Mencinger (2003) stated that FDI greater impact on import than on exports can harm the balance of payments and on the whole economy of the host country. Multinational firms are more oriented to imports than to exports because these firms have a greater need for goods and raw materials and the host countries can not satisfy their needs, either in quantity or in quality (OECD, 2002).

Blomström and Kokko (1998) argued that FDI create additional competition in the host country which have an important role in improving the factors of production and accumulation of capital. The entrance of new foreign players into the host country's market increases the supply side, so local companies have to increase their market share what will increase the production, lower prices of products and services and effective allocation of resources to be able to compete against multinational companies. These actions result in additional investments in the research and development of local firms and in such cases, these firms try to exploit the efforts they made to make certain improvements to get more market share and also to compete on the international level. In addition, De Mello (1997) stated that domestic firms in a host country to be able to face competition have to improve their technology and methods of production, invest additional financial resources in equipment and its employees. Furthermore, Görg and Greenaway (2004) added that in cases when local firms are unable to duplicate the technology and production process of multinational companies, they are under additional pressure to use existing technology more efficiently. Although increased competition has positive effects in general it does not guarantee the economic growth of the host country. There are examples when some local firms can't compete with multinational companies because of the advantages they have in certain areas which provoke the unavoidable closure of some local firms which in turn will lead to a reduction in competition and lower economic performance in the host country. Pavlinek

(2004) analysed the potential positive and negative effects of FDI in the host countries. The detailed review of potential positive and negative effects of FDI in the host countries is displayed in the table 2.

Table 2. *Potential positive and negative effects of FDI in host countries*

<b>POTENTIAL POSITIVE EFFECTS</b>
<b>Company level</b>
Continued and expanded production
Greater labor productivity
Easier access to investment capital
Engagement to worldwide sale and distribution networks
Transfer of Western advanced technology and know - how
Greater competitiveness
Bigger investments in research and development function
<b>Local and regional economy</b>
Creation of new workplaces and decrease of unemployment
Increase of salaries
Increase of real income
Growth of tax base
Increased exports
Well trained workforce
Provision of social services to local communities
Spillovers to local and regional economy
Greater opportunities for local companies to supply foreign-owned companies
<b>POTENTIAL NEGATIVE EFFECTS</b>
<b>Company level</b>
Decrease of work
Disinvestment and decrease of production
Transfer of research and development foreign owners
<b>Local and regional economy</b>
Local economies and local companies start to depend on foreign capital
Local economies are controlled by external parties
Attracting skilled and semi-skilled workers from local companies
Smaller possibility for development of new enterprises
Deskilling
Regional specialization in low-skilled, labor-intensive production
Instability of Western investments

*Source: Pavlinek (2004).*

## 1.6 FDI trends

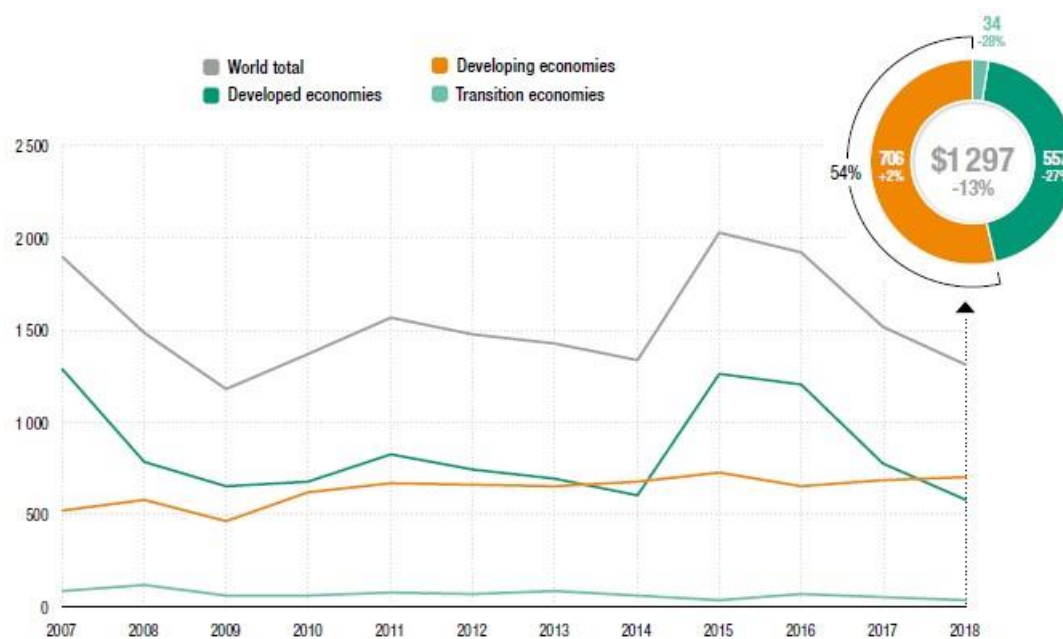
After the increase of FDI in 2015, weak economic growth and experienced policy risks by multinational companies resulted that global flow of FDI was declined by 2%, to \$1.75 trillion in 2016. In 2016 the level of FDI mostly decreased in developing countries, which was compensated by the increase of investments in developed and

transition countries. The highest rise of FDI was recorded in developed countries since these countries absorbed 59% of the total level of FDI in 2016 (UNCTAD, 2017).

Although for 2017 it was predicted rise of FDI flow, according to UNCTAD (2018) the FDI flow continued to decline and reached the value of \$1.43 trillion in 2017. The decline of FDI flow in 2017 was completely in opposition with macroeconomic variables such as GDP and trade since the values of these variables improved a lot in 2017 compared to 2016. The value of net cross-border merger and acquisitions was also decreased from \$887 billion in 2016 to \$694 billion in 2017, which also contributed to the decline of FDI flow. Moreover, the value of greenfield investments declined by 14% to \$720 billion. When talking about the group of economies, the FDI flow declined suddenly in developed and transition economies, while the level of FDI flow in developing economies remained stable. The total level of FDI inflow in developing countries represented a growing share of global FDI inflow and was equal to 47% of the total level of FDI inflow in 2017 (UNCTAD, 2018). This negative cycle was mainly caused by the significant decrease in rates of return on FDI in past few years.

The flow of FDI continued to decrease in 2018, falling to \$ 1.3 trillion. According to UNCTAD (2019), in the first two quarters of 2018 and attributable to the implementation of United States tax reforms at the end of 2017, the third consecutive decrease in FDI inflow occurred as a result of substantial repatriations of accumulated foreign earnings by United States multinational corporations. Despite the increase in the value of cross-border mergers and acquisitions from \$694 billion in 2017 to \$816 billion in 2018, the decrease in FDI flow was recorded. In addition, the value of greenfield investments raised up 41% from \$698 billion in 2017 to \$981 billion in 2018. During 2018 developed economies and economies in transition experienced a decline in FDI flow, while FDI flow in developing countries increased by 2% compared to 2017.

Figure 1. *FDI inflows, global and by group of economies, 2007–2018*



Source: UNCTAD (2019).

In 2016 the level of FDI flows in transition countries reached the amount of \$ 68 billion, after a steep decline in the previous two years. In the two main sub-regions, the different trends of FDI were recorded. On the one hand, the Commonwealth of Independent States (hereinafter: CIS) and Georgia recorded an increase in FDI flows due to the rise of FDI flows in Russia and Kazakhstan. On the other hand, SEE countries experienced a fall of FDI flows of 5%, as a result of less investment in the manufacturing sector. In 2017 the level of FDI flows to the transition SEE countries and the CIS declined by 27% to \$ 47 billion, following the global trend in 2017. It was the second-lowest level of FDI flows since 2005. This decline happened due to the weak FDI flows to the biggest four economies of the CIS. Contrary, Georgia, Serbia and Montenegro experienced growth but it was insufficient to cover the losses of larger economies in the group.

The FDI flow to the SEE transition countries and the CIS continued to decline in 2018 as the overall value of investments in the region declined by 28% to \$34 billion. The deficit of FDI flow was driven by a shortage of FDI to the Russian Federation, the country with the largest economy and largest receipt of FDI in the group, from \$26 billion to \$13 billion. Also in other FDI recipient countries such as Azerbaijan, Kazakhstan and Ukraine, the decline of FDI inflow was recorded. In contrast to the decline of FDI flow in Russia, Azerbaijan, Kazakhstan and Ukraine, the SEE countries especially Serbia and North Macedonia experienced growth of FDI. All countries of the SEE region except Montenegro experienced a rise in FDI inflows, while FDI outflows remained unchanged at \$38 billion.

## **1.7 FDI flows in SEE countries**

SEE is a geographic region of Europe, composed of 12 countries, including countries on which this master thesis is based - Albania, Bosnia and Herzegovina, Bulgaria, Croatia, North Macedonia, Romania and Serbia. There are many definitions about where exactly SEE begins, and where it ends as well as how this region relates with the other parts of Europe.

Although Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania and Serbia share some common characteristics not all of these states are equally successful in attracting FDI. These countries have many things in common such as shared history and similar transition experiences. Also, these countries were affected by war and political and economic stability were on the lowest possible level in the 1990s. The whole situation provoked the slow economic recovery and economic reforms which led to that these countries lag behind the Central and Eastern Europe (hereinafter: CEE) region. Although these countries made progress in many directions during the 2000s, investment opportunities and economic potential are not recognized due to continuous links of the Balkan region with war conflicts. Additionally, the unstable political situation of the region as well as the change of transition to market economy resulted in a low level of FDI in most SEE countries. Political processes, as well as negative events, caused negative trends. Namely, at the beginning of the 1990s, political instability caused deep consequences. Moreover, such unresolved political problems are still present and remain the main problem of the region.

Except for Slovenia, the above-mentioned events from the beginning of the 90s caused negative economic implications to countries of former Yugoslavia. Finally, the decomposition of the former Yugoslav federation caused demoralization of traditional economic and trade links, recession, untimely economic reforms. Those events also jeopardized the integration of SEE countries with the European Union (hereinafter: EU) (Uvalić, 2012). During the 1990s Bulgaria and Romania also experienced negative economic trends and postponed many important economic reforms. After a decline in GDP in the first half of the 1990s, many SEE countries also had negative economic growth in the second of the decade too. Bosnia and Herzegovina, Montenegro and Serbia experienced slow economic recovery and by 2011 these countries did not reach their GDP level from 1989. Assimilation with the rest of Europe has also been characterized as a slow process. Bulgaria and Romania signed an Association Agreement with the EU in 1993 and they became part of the EU in 2007. Other countries of the SEE region were not able to improve their political and economic connections with the EU until 2000.

The improvement of the political and economic environment increased the FDI level to SEE countries. Serbia and Croatia, who were named as the key countries of the region, developed more democratic regimes in the early 2000s. Such development resulted in the improved economic performance of the whole region. From 2001 SEE countries initiated trade liberalization with the EU and within the Balkan region. Those actions also resulted in the improvement of the business environment, privatization of many enterprises and privatization of almost the entire banking sector. From 2001 to 2008 these countries were characterized by stable macroeconomic indicators, relatively strong GDP growth, an increase in foreign trade and countries got closer to more advanced transition countries.

The EU developed the Stabilization and Association Process for Western Balkan countries with a primary objective to stabilize the region and also offering several other benefits such as trade liberalization measures, financial assistance program, contractual relations and the possibility of EU membership if countries satisfy certain criteria. In 2007, Bulgaria and Romania joined the EU, while Croatia accessed the EU in 2013 becoming the 28th EU member. These three countries are the only ones to be members of the EU. Albania, Macedonia and Serbia are EU candidates, while Bosnia and Herzegovina is a potential candidate.

SEE countries avoided the general trend of the downfall of FDI inflow since the FDI flows in this sub-region increased by 34% to \$7.4 billion in 2018. The rise of FDI flows was distributed almost among all countries of the SEE sub-region. Due to the absence of sufficient domestic savings, FDI represent an important opportunity for the development of North Macedonia's economy. According to the data from UNCTAD (2019) World Investment Report, the level of FDI in North Macedonia reached the value of \$737 million, compared to \$205 million a year before. The level of FDI stock of North Macedonia was equal to 47.1% of the total country's GDP, with \$5.9 billion in 2018. The north Macedonian government took a set of reforms to improve the business environment and to make it favourable for multinational companies. UK and Austria are the two largest foreign investors in Macedonia, followed by Greece, Netherlands and Slovenia. The investments from these countries represent 51% of the total FDI in the country. These countries mostly invest in the manufacturing sector, heavy industry, light industry and in the construction sector, also financial and insurance activities are interested to foreign investors. Although the Macedonian government took a series of measures to improve the business environment in the state there are still some challenges they have to overcome such as corruption, lack of transparency, poor customer service, interference in the judiciary and excessive bureaucracy. In the Doing Business report 2020 published by World Bank (2019a), Macedonia is positioned at high 17th place out of 190 countries.

In 2018 Serbia increased its inflows by 44% to \$4.1 billion from \$2.8 billion in 2017 stimulated by growth in equity capital and as a consequence of the improved business climate of the country. This is the reason why it became the second-largest recipient of FDI among transition countries. The level of FDI stock of the Serbian economy in 2018 was \$39.8 billion which represented 78.6% of the country's GDP. The economy of the country is much diversified and it is the largest within the SEE sub-region. The highest percentage of FDI in Serbia falls on the EU with 70% of investments, followed by Russia, Switzerland, and Hong Kong. The country's strategic location accelerates investments in logistic such as investments in Nikola Tesla Airport in Belgrade by Vinci Airports company from France. Also, the abundance of the country's natural resources attracts resource-seeking firms. For example, The Zijin Mining Group from China invested in RTB Bor's copper production. Furthermore, the country's skilled workforce attracts investments in the growing automotive industry, such as the investments of wire production by company Essex based in the United Kingdom and production of cables by Yazaki company based in Japan. In addition, the country's knowledge base attracts research and development centres, such as the development centre in Novi Sad of German company Continental which is specialized in the production of tires. The Serbian government plans to continue with offering incentives to foreign investors to keep improving the business climate of the country. The most significant progress in making the business environment favourable for foreign investors concerns economic reforms, the strategic location of the country, inexpensive and skilled labour force and also the country made significant progress in issuing constructing permits and the tax payment system. Serbia is ranked at 44th place in the Doing Business report 2020 published by World Bank (2019b).

In 2007 Bosnia and Herzegovina recorded a record amount of FDI in the amount of \$ 1.8 billion due to the series of measures that the government took at the beginning of the 2000s to improve the business climate of the country and to attract FDI. The decrease of FDI in Bosnia and Herzegovina was affected by the global economic crisis which led to a drop of FDI in 2018 to a value of \$468 million which represents an increase of FDI for \$20 million compared to 2017. The total FDI stock was projected at \$8.3 billion in 2018 which represented 41.9% of the country's GDP. The four main investors in Bosnia and Herzegovina are Austria, Serbia, Croatia and Russia. Manufacturing, banking and telecommunication sectors receive the most foreign investments, while multinational companies also invest in trade and financial services. Foreign investors are mostly attracted by low levels of corporate taxation, well-developed industrial zones, solid banking sector and strategic location. The main problems multinational companies face when investing in Bosnia and Herzegovina are a lack of transparency of administrative procedures, weak judicial system and dual nature of the State. According to the World Bank (2019c), Bosnia and Herzegovina is ranked at 90th place in the Doing Business report 2020.



After an increase in the level of FDI from 2005 to 2008 in Croatia, after that period level of FDI inflows dramatically decreased as a consequence of the global economic crisis. After then, FDI flows shown signs of recovery in 2014 when there was recorded the highest level of FDI since 2009. According to UNCTAD (2019), in 2018 the value of FDI inflow to Croatia was \$1.15 billion, \$2 billion less than in 2017. The level of FDI stock was \$32.8 billion in 2018 which amounted to 54.2% of the country's GDP. The sectors like financial services, wholesale, real estate and telecommunications recorded the highest number of investments, while the main investors come from Netherlands, Austria, Italy and Germany. Although the government took series of measures to improve the business climate, Croatia still has an image of a country linked with corruption, high taxes and an inefficient judicial system. Despite these negative things Croatia still has a high-quality infrastructure, huge touristic potential, a well-educated workforce and a strategic position. World Bank (2019d) placed Croatia at 51st place out of 190 countries in the Doing Business report 2020.

Since the early 2000s, the level of FDI in Albania has been rising constantly, almost \$1 billion per year from 2008 to 2017. In 2018 the level of FDI inflows amounted to \$1.3 billion, experiencing a slight decrease from \$1.14 in 2017. The value of FDI stock in 2018 was \$7.9 billion, which amounted to 52% of the country's GDP. The sectors which attract the most foreign investments are oil, metal ore, infrastructure and telecommunications. The four main investors in the country are Switzerland, Netherlands, Canada and Greece. The Albanese government took a set of reforms to improve the business climate and boost FDI. Their tax system has been reformed which is favourable for foreign investors and they also strive to reduce corruption and administrative difficulties since corruption and administrative barriers can discourage potential investors. The investment progress has been slowed down to some extent due to long-term procedures to obtain licenses for operation in construction, trade and tourism industries. Also, the lack of infrastructure and inadequately designed property law could slow down investment progress. At the beginning of 2018, the Albanese government adopted new law aiming to attract new investments. The new law will enable compliance with labour, safety and environmental legislation and establishing procedures that will enable foreign investors to start their business quicker. According to the World's Bank (2019e) Doing Business report 2020, Albania is positioned at 82nd place out of 190 economies.

Although Bulgaria retained a steady growth of FDI inflow in the early 2000s and reached a peak in 2007 at \$12.4 billion, after that the level of FDI inflow has been on a decline as a consequence of the global economic crisis, Eurozone crisis and also Greek crisis because Greece was one of the biggest investors in Bulgaria. According to UNCTAD (2019), the level of FDI inflow decreased to \$2.05 billion in 2018. At the end of 2018, the total stock of FDI was \$ 49.2 billion which represented 75.9% of the

country's GDP. The most important foreign direct investors for the country are the Netherlands, Austria, Germany and Italy, while sectors such as real estate, manufacturing, financial and insurance activities attract the highest number of investments. Since the country offers one of the lowest corporate tax rates in the area and low labour costs it is the preferred place for investments. The main challenges which foreign investor face when invest in Bulgaria are insufficient skilled labour force, corruption and unpredictable regulatory and legislative framework which is subject to frequent modifications. Also, the judicial system is slow and the protection of intellectual property rights is not always applied. Currently, Bulgaria is ranked at 61st place out of 190 countries according to the World's Bank (2019f) Doing Business report 2020.

In 2018, the level of FDI inflows in Romania was \$5.8 billion, which is a slight increase compared to the year before when the value of FDI inflows was \$5.4 billion. The total FDI's stock amounted to \$94 billion which was equal to 39.2% of the country's GDP. Manufacturing, construction and real estate transactions attract the most foreign investments while multinational companies also invest in trade and financial resources and insurance. The largest investors in the Romanian economy are Austria, Italy, Netherlands, Germany and Cyprus. Romania offers several advantages to investors: a large domestic market, strong industrial tradition, and lowest labour cost rate in the EU. Although the Romanian government launched a fight against corruption in 2016, which made the country more business-friendly and favourable for foreign investors, corruption is still a problem for foreign investors as well as legislative instability and weak judicial independence. Currently, the country is ranked at 55th place out of 190 countries in the Doing Business report 2020, published by the World Bank (2019f).

The table 3 shows the FDI's stock level and FDI per capita level for seven SEE countries mentioned above for 2016, 2017 and 2018.

Table 3. *The FDI's stock and FDI per capita level of SEE countries*

Country	FDI STOCK (million USD)			FDI per capita (USD)		
	Year					
	2016	2017	2018	2016	2017	2018
North Macedonia	4,909	5,634	5,961	2,359	2,706	2,862
Serbia	30,369	37,573	39,833	4,302	5,212	5,705
Bosnia and Herzegovina	6,918	8,247	8,330	2,043	2,461	2,506
Croatia	27,602	33,469	32,884	6,612	8,115	8,041
Albania	4,985	6,739	7,902	1,733	2,345	2,757
Bulgaria	42,994	51,047	49,276	6,032	7,214	7,015
Romania	73,906	90,968	94,021	3,751	4,644	4,828

Source: *Unctad (2019) and own work.*

## **2 THEORETICAL BACKGROUND OF INVESTIGATION**

This chapter explains the theoretical background of Dunning's OLI framework. The framework explains the main motives why multinational companies invest in foreign markets. The main question which dominates among scientists is why companies decide to expand to foreign markets where domestic companies have a better understanding of local market conditions, customer habits and business environment by using FDI strategy rather than using licensing or exporting strategies. Among other main theories which explain the FDI are: Production Cycle Theory of Vernon, The Theory of Exchange Rates on Imperfect Capital Markets and The Internalization Theory. Also, the institutional theory will be explained as a part of the theoretical background of the investigation.

### **2.1 OLI framework**

To explain the strategies of multinational companies in the international market, John Dunning developed the OLI theory. His goal was to merge different theoretical methodologies and models into one theory that would explain the behaviour of multinational companies in the international market. The OLI theory is considered as a simple theory, but also it represents a viewpoint that indicates that the geographic position and industrial structure of foreign production by multinational companies depend on the interaction of three sub paradigm: ownership advantage, location advantage and internalization advantage. This means that multinational companies to be competitive in the foreign market have to own these three advantages in comparison to local companies. The impact of the OLI theory is double. First, it explains why companies are engaged in abroad investments and their motivations for FDI and second depends on the mode of how multinational companies enter a foreign market.

### **2.2 The advantage of ownership**

Understandably companies which operate in foreign markets are exposed to greater production costs and risks compared to the costs of the local companies. The additional costs arise due to the following circumstances:

- weak knowledge of domestic market conditions,
- differences in the legal, institutional, cultural and language context
- high costs of working due to the operating at a distance.

In order to be able to operate successfully abroad, multinational companies must have a specific advantage of possession compared to other companies in the same market that will reduce additional costs that arise due to the elements of foreign. These advantages

are manifested in owning a particular production process, material resources, managerial talent, blueprint, application of new technologies, patent, trademarks and many other assets. Ownership advantage may also include a product that has market power and advantage in foreign market and property that can be moveable within a company and between different countries. Enjoying different ownership advantages, multinational companies are capable to earn higher profit for the same expense compared with the local companies. Foreign companies also need to take into consideration the costs of operating at a distance. Ownership advantage represents certain assets that are characteristics of particular companies. These assets shouldn't be at disposal to other companies but they should be transferable abroad and used in more than one place at the same time in order to create a prerequisite for FDI to occur.

### **2.3 The advantage of location**

The possession of the advantage of ownership for a multinational company is not enough for a successful business in a foreign country. Since the operations in foreign markets are connected with higher production costs and greater exposure to risks, multinational companies together with the advantage of ownership must have additional arguments for conducting business in these markets. Therefore, the advantage of location represents determining factor in deciding which country will be chosen for FDI by multinational companies. The presence of strong location advantages is very significant because these benefits minimize the manufacturing costs of multinational corporations in that region. Opposite to the ownership advantages, these advantages can't be moved to another location but can be used at the same time by many businesses.

According to the Dunning (1993), the location advantages can be divided into following categories:

- economic advantages are those advantages that include the price of raw materials, transport costs, market size, country's infrastructure, low communication costs, cheap workforce and etc.
- political advantages refer to the political stability in the country, different political risks, government's attitudes towards FDI, taxation policy, institutional framework and etc.
- social and cultural advantages include low crime rate in the country, high living standard, varieties in language and culture, positive attitude towards foreigners and etc.

Although among location advantages, economic advantages (such as low-cost workforce, cheap raw materials, transport costs, market size, etc.) are characterized as most attractive to multinational companies, institutional factors becoming more and

more important for foreign investor's mindset. Institutional framework affects the flow of FDI in a country in sense of attracting or deterring it. Pournarakis and Varsakelis (2004) argued that institutional factors which influence the decision of foreign investors make some countries more favourable for investments compared to others and help these countries to become an attractive location for foreign investors. Government can positively influence the flow of FDI in the country providing different incentives such as financial, fiscal, lower tax rates, lower level of corruption in the country, etc. So, if a country wants to become attractive for multinational companies and attract as many as possible FDI it must have good quality institutions that will enable it.

#### **2.4 The advantage of internalization**

Besides the advantages of ownership and the advantages of location which explain why and where companies invest when expanding abroad, the advantage of internationalization describes how companies enter the international market. The advantage of internationalization seeks to give answers on how multinational companies will utilize their ownership advantages, will it be done through export, licensing or FDI. There are two ways when the advantage of internationalization occurs. The first case when it occurs is when the company's advantages of ownership are easy to be copied by other companies. So, if a company wants to protect its assets it is better to produce within a company than rather than licensing it to another company. The second case when the advantage of internationalization can occur is when it is hard to reach an agreement between two companies for the production of certain goods or services. In this case, for a company is better to produce a product or service within the company and in that way keep the whole control over the production process. Motives, why multinational companies outsource certain activities to other companies when they go abroad, might be because they have more competencies, they can do it at a lower cost, have better knowledge about local market conditions, etc. When a multinational company decides to integrate into the international market and to be competitive with other companies it has to allocate an enormous amount of money. One of the most important costs represent the costs of management, also if a company wants to launch a new business line, a new type of competence may be required which the company doesn't possess and it can cause additional costs. All facts above mentioned explaining that multinational companies have to consider many things when choosing entry mode and this decision has to be taken seriously.

Dunning (1993) stressed out that each of these three advantages is extremely important in deciding for investment to be made. These advantages can be compared with the chair with three legs, where each leg is considered to be important for maintaining the balance of the chair. Therefore, according to the eclectic paradigm, the company will

expand abroad if all three advantages described in the OLI framework are simultaneously satisfied.

Dunning (1993) stated that based on the OLI framework multinational enterprises can be divided into four categories:

i) Resource seeking: the fundamental target of companies which fall into this category is to obtain different kind of resources which can't be found at a home market such as different natural resources and raw materials. They also strive to find resources that are offered at lower cost in the host country comparing to the home country such as the unskilled labour force.

ii) Market seeking: in this case multinational companies decide to invest abroad because they want to utilize possibilities that are offered by large markets outside the home country. Except researching and utilizing new markets, these types of companies have started to build up production facilities abroad, adapt products to local needs and tastes and reduce the costs of operating from their headquarters (in origin country). Recently it is also crucial to be physically present on the market to be able to push down potential competitors from the market.

iii) Efficiency seeking: Eckel (2003) stated that this category overlaps or it is very similar to the category of resource seeking because it describes activities of reallocating the part of the production line abroad to use minimized costs of production in less developed countries. It is considered that the motive of multinational companies for efficiency-seeking is that multinational enterprise can benefit from the joint governance of geographically distributed operations. Dunning (1993) argued that to minimize operational costs and to supply numerous markets, multinational corporations tend to take advantage of different factor endowments, economic systems, cultures, policies and market structures to concentrate production in a small number of locations.

iv) Strategic asset seeking: this category refers to the investments of multinational companies that are involved in acquiring and supplementing the new technological base, rather than the exploitation of already existing supplements. This category does not fit the OLI theory proposed by Dunning (1977), as the main motive for companies investing abroad is to gain access to knowledge or competencies that are not within the company. Authors like Rugman and Nguyen (2014) argued that Dunning made a mistake when added the fourth motive for FDI.

### **2.3 Institutional theory**

Although institutional theory doesn't belong to the group of FDI theories, this theory is considered important because it has a great impact on the behaviour of multinational companies in choosing appropriate location for making abroad investment.

Institutional economics has been developed between the 19th and 20th century and Coase (1998) stated that institutional economics deals with the systems that restrict the exchange of resources and have an impact on economic phenomena. Institutions are governing factors of the economy, which represents the fact that gives institutional economics importance. According to Hodgson (2003), there is a distinction between "old" institutional economics and "new" institutional economics (hereinafter: NIE). The two main representatives of NIE are North and Williamson. Development of the NIE was held in the middle of the seventies of the 20th century, as a direct response to the dominant neoclassical and liberal economic concept. The theorists of NIE believe that the neoclassical theory is not an adequate tool for analysis and for determination of assurance of arrangements that would empower advancement because the agents of neoclassical hypothesis have the sentiment that exchanges don't cost anything, that data is accessible for nothing and that states are good-natured. NIE is important for attracting FDI because institutions in the form of law, a political system, culture or educational system of the country have an impact on the number of exchange costs and consequently the success of the country's economy (Coase, 1998). Institutions play a vital role in increasing the functionality of society, especially in economic efficiency. They represent a vital part of social capital as a key factor of economic growth and economic success. Institutions reduce risk by a decrease of the information's costs, encourage creation and movement of capital and enable the assessment and share of operational risks which makes cooperation easier (Budak and Sumpor, 2009). North (1990) characterized institutions in a more extensive sense as formal and casual standards of the game in a general public which decide the relational relationship among individuals. There are two types of institutions. Formal institutions are set up by competent authorities and by political entities which include (rules, laws, regulations, property rights, social infrastructure, etc.) and informal institutions which represent unwritten rules of society (behavioural norms, self-imposed codes of conduct, customs, traditions, etc.) and their features of enforcement. The importance of informal institutions is higher in politically unstable and less developed countries in the world. The actions of informal institutions can strengthen formal rules, or block institutional change because these institutions show significant inertia and change gradually. In an ideal case, formal and informal institutions complement each other and the institutional structure is considered to be complete only when both formal and informal institutions are taken into consideration.

North (1993, 1994) claimed that difficulties arising from economic development require better institutional support. Depersonalized exchange, drastic reduction in costs of information, rapid specialization, urbanization, growing uncertainty because of the increasing interdependence of individuals, the weakening of the role of the family in society and other global phenomena rapidly lead to the transformation of society. Therefore political and economic institutions must monitor the dynamics of socioeconomic changes to ensure the success of development policies. Consequently, the analysis of institutions must take place while monitoring the development of economic changes.

In transition countries, together with political changes, economic reforms have had to ensure development and faster economic growth within a relatively short period, but instead, these reforms lasted longer than expectations were. Analysis's and theorists finding the causes of underdevelopment in the inadequate institutional framework within political and economic reforms took place. Political and economic reforms led to the abolishment of the institutions of the former system but these institutions were replaced imprecisely and inadequately. For the successful application of economic policy measures and proper functioning of the market, there is a need for stable political surroundings and social consensus and therefore the existence of quality institutional framework with aims to regulate property rights, presence on the market and other factors which are important for the proper functioning of the market.

The new EU member states stand out for measures of economic success within the group of transition countries. The great division between these countries is a result of the divergence of the system of advanced transition countries and the group of countries that lag in the areas of economic growth, investment volume, macroeconomic stability, public finance and infrastructure. Since these advanced transition countries were in the process of joining the EU, the conclusion is that the EU has played important role in the financial and economic development of these countries. The association process has removed national political obstacles in the countries of the CEE region. Fulfilment the requirements for membership was a crucial for the adoption of laws and policies, but it seems that the desire to join the EU was even more important.

### **3 INSTITUTIONS AND FDI**

#### **3.1 The role of institutions in attracting FDI**

When analysing the level of FDI inflows in particular locations and determinants that attract multinational companies to invest, the quality of the institutional framework of the country targeted for investments was not usually taken into consideration.



Moreover, the governments of host countries did not consider the role of institutions much important in attracting foreign capital into their countries.

Three elements compose the institutional structure: formal rules, informal rules and enforcement mechanism. Formal rules represent the written laws that regulate society. Examples of formal institutions can be considered regulation of banks, imposition of tariffs and quotas, laws governing contracts, crime, political situations and product information. These rules can be developed by different firms and also by government (North, 1990). Contrary informal rules represent the unwritten rules that control the social life. They include culture, behavioural expectations and behavioural codes. Informal rules might differ from nation to nation. The third component of the institutional framework is enforcement. This aspect is responsible for the effective application of the rules. Ali, Fiess and McDonald (2010) found that quality or good institutions minimize the cost of doing business and improve profitability from the economic activity.

Based on the area that they regulate, there are three categories of institutions: economic, political and social. Duumludag, Saridogan and Kurt (2009) in their research paper explained the meaning and role of each category. Economic institutions regulate the economic transactions in the country and they are responsible for the effective protection of property rights and contracts enforcement. Political institutions regulate the political situation in the country and they determine the election process in the country, these institutions develop the laws that govern how a new president or new government will be elected. Social institutions deal with the proper enforcement of laws and punishment of those who violate the rules. According to North (1990), all institutions are important for the proper functioning of the state, but political institutions stand out as more important than other institutions because political institutions manage how other types of institutions are created.

The level of institutional quality predominantly depends on the effective implementation of government policies and on the characteristics of political and social institutions. The low level of political and social risks, proper regulatory framework, stable political situation, effective protection of property rights, the rule of law, anti-corruption system and efficient bank system encourage investment and stimulate productivity. For example, when political stability is on a high level and the judiciary system is effective, foreign investors feel safe that their property rights will be protected in the right way. Ineffective protection of property rights may cause expropriation which discourages foreign investors from investing in particular locations. The low level of corruption leads to fair competition in the market removing barriers for investors. The taxation system is also an important determinant since high taxes may

lead to low productivity and to discourage of potential investments. Certain tax exemptions might encourage investors and facilitate production growth.

### **3.2 Literature review of the institutional determinants of FDI**

Although many researchers have recognized the importance and impact of quality of regulation on the inflow of FDI, just a few authors dealt with the concept of regulatory determinants and their effects on attracting FDI. The available literature mostly emphasizes the role of the market size, economic reforms and labour costs as the key factors influencing the inflow of FDI while the role of institutions has fallen into another plan.

One of the first scholars who investigated the influence of institutions on FDI flow were Wheeler and Moody (1992). Analysing 13 risk factors including quality of a legal system, corruption, bureaucracy and political instability, they didn't find out that institutional quality had an impact where US companies located their foreign affiliates. However, their research also included variables such as the degree of discrimination and environment of expatriates which are not linked to institutional efficiency.

Dunning (2002) accentuated that institutional determinants like good governance and free economic trade are becoming popular and significant determinants of FDI since multinational companies decided to make a reverse in their international strategies from resource seeking to efficiency-seeking. Moreover, Addison and Heshmati (2003) added that traditional factors that attracted FDI like natural resources, raw materials and low-cost workforce becoming less important in comparison with less traditional factors like good governance and economic freedom.

According to Bevan, Estrin and Meyer (2004), institutions represent a decisive factor of location advantage for the attraction of FDI. Multinational enterprises consider institutional quality as an important aspect of the host country when deciding where their foreign affiliates will be located. They highlighted that a good institutional framework generally boosts the level of FDI inflow and identified aspects that have a positive effect on FDI receipt. They are the growth of the private sector, banking sector development, foreign exchange, trade liberalization and legal development. Besides that, Globerman, Shapiro and Tang (2004) identified that good governance improves the level of both inflow and outflow FDI. Furthermore, they identified that joining the EU, or even the possibility of approaching the EU increase the probability of FDI to occur. This kind of political activity offers some kind of protection to foreign investors that institutional reforms made by transition countries will not be reversed.

Furthermore, Daniele and Marani (2006) identified three channels by which institutions may influence the level of investments. First, the existence of good institutional quality leads to the improvements in factors of productions that can stimulate investments. Secondly, good institutional quality can reduce investments related to transaction costs. Thirdly, multinational enterprises invest a large amount of money in host countries. Therefore, a good institutional framework and its proper functioning will contribute to the greater credibility and security of multinational enterprises. Moreover, Busse and Groizard (2006) confirmed that countries need to have the good regulatory quality to exploit the benefits offered by FDI. Besides the quality regulatory framework, they also stressed that the presence of good institutions is important as well.

Rammal and Zurbruegg (2006) investigated the effect of regulatory quality and governance practices on the FDI flows between five economies of Indonesia, Malaysia, Philippines, Singapore, and Thailand using panel data set. The acquired outcomes demonstrated that ineffective application of investment regulations in foreign trade had damaging effects on FDI flow between five selected countries and represent a substantial factor in explaining the downward tendency in FDI flows. The conclusions of their paper showed that multinational enterprises which want to invest in these countries are guided by the level of regulation quality in the host country. Regulations designed to encourage trade openness to enable the host country to achieve a competitive advantage which helps to encourage FDI inflow. Also, on a sample of 17 countries from Asia, Latin America and Caribbean regions Gani (2007) managed to demonstrate that rule of law, control of corruption, regulatory quality, government effectiveness and political stability are positively significant with the inflow of FDI.

Laabas and Abdmoula (2009) deployed a gravity model based on panel data of 17 Arab countries for the period from 1998 to 2007 to analyse determinants that have an impact on Arab interregional FDI flow. They tested the influence of institutional determinants that have an impact on the quality of business and investment environment and also analysed different risks that foreign investors encounter. World Bank governance indicators were used which measured political stability, control of corruption and regulatory framework. They concluded that political stability and control of corruption negatively impact the FDI flow since FDI in the Arab region mostly occur between countries with low institutional development, also some investments are made by government investment agencies or simply investors don't see potential threats because due to the operation in bad institutional environments. Unlike, political stability and control of corruption which showed statistically insignificant for FDI flow, regulatory quality is positively associated with the Arab interregional FDI flow.

Using a panel of 69 countries from 1981 to 2005, Ali, Fiess and McDonald (2010) analysed the role of institutional quality and institutional variables in attracting FDI.

They studied variables like GDP growth, trade ratio, inflation, institutions, size of the government, human capital, property rights and natural resources. It was concluded that institutional quality is a significant factor in attracting FDI. By comparison of protection of property rights with other variables such as democracy, corruption, a political situation they found out that protection of property rights represents the most important institutional aspect.

Jadhav and Katti (2012) investigated the influence of political and institutional factors on FDI inflow in Brazil, Russia, India, China and South Africa (hereinafter: BRICS). They analysed a period of ten years from 2000 to 2010, using panel unit-root test and multiple regression. Determinants like macroeconomic stability, political stability, government effectiveness, regulatory quality, control of corruption, voice and accountability and rule of law were used in the study to examine which determinants have the greatest impact. The findings of investigation showed that two determinants, namely government effectiveness and regulatory quality, were positively correlated with the inflow of FDI into BRICS. The other three variables, political stability, voice and accountability and control of corruption showed to have a negative effect on the inflow of FDI into BRICS countries, which means that these three factors are not relevant for foreign investors when investing in these countries.

Based on the analysis of a panel of 164 countries from 1996 to 2006 Buchanan, Le and Rishi (2012) investigated the impact of institutional quality on the level of FDI. Their opinion was that a good institutional climate has effects on the level of FDI. The theory was supported by different pieces of evidence which claimed that good institutional quality has a positive and important influence on FDI. They came up to the conclusion that a change of one standard deviation in institutional quality improves FDI for the factor of 1.69. Generally speaking, countries with better institutional quality will bring in more FDI, while weak institutional quality harms the level of FDI inflow.

Saidi, Ochi and Ghadri (2013) researched the role that macroeconomic variables and governance indicators have on the attraction of FDI in 20 developed and developing countries for the period from 1998 to 2011. The analysis showed that only two governance indicators are particularly important for the attraction of FDI, specifically political stability and regulatory quality. This analysis demonstrates that foreign investors only look for a political stable and regulatory quality environment when investing abroad.

Lucke and Eichler (2016) conducted panel regression for 65 countries in the period from 1995 to 2009 and as a result, found that regulatory quality and economic freedom positively influence the level of FDI inflow. While on the other side, analysing developed countries they didn't find a positive correlation between regulatory quality

and economic freedom with FDI inflow. In general, obtained results demonstrated that foreign investors are willing to invest in locations that have a comparable or better regulatory environment than in home countries.

Although many scholars supported the hypothesis regarding the significance of institutional quality to FDI inflow, the empirical studies are quite different and some scholars don't support the fact that institutional quality matters in attracting FDI. For example, Jensen (2003) focused his study on 114 developing countries across the world using panel regression from 1970 to 1997. His findings were that expropriation, level of corruption, bureaucratic framework, rule of law are not important determinants for FDI inflow, while on the other hand trade openness and economic growth represent important determinants in attracting FDI. This assumption leads to the conclusion that foreign investors are led more by the macroeconomic framework rather than institutional quality when deciding where to invest. On the contrary, Busse and Hefenker (2005) during their analysis of 83 developing countries from 1984 to 2003, found out that foreign investors pay attention the most to factors such as government stability, rule of law, quality of bureaucracy and democracy level while the macroeconomic framework characterized by inflation and corruption showed as less important determinants.

Daude and Stein (2007) performed the analysis of a broader set of institutional determinants that affect foreign investors' decision-making process when undertaking investment in a particular country. Analysis of a broader set of determinants enabled them to assess which determinants influence the most investors' decision where to invest. They used a set of institutional variables developed by Kaufman. These variables are Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. Voice and Accountability measures how much citizens may participate in selecting the government, it also measures their freedom of expression, freedom of association and free media. Political stability refers to the government's ability to defend oneself from government destabilization or disturbance including violent or unconstitutional means and politically motivated violence. The quality of the public service and the civil service and their freedom from political pressures are calculated by government effectiveness. It also measures the consistency of policy formulation and its implementation and the degree to which the government is committed to policy formulation. Regulatory quality refers to the capacity of the government to develop and enforce policies and regulations adequately. Rule of law measures the degree to which government respects the compliance of the contract, the protection of property rights and the adherence of the country to the laws and regulations. Control of corruption measures how much public power is used by private entities to accomplish their benefits. Using the model of unobserved components authors managed to cover 160 developing countries studying each of the indicators

mentioned above. Institutional quality has proven to be a very important factor to analyse when undertaking investment in a particular country. Furthermore, they found out that all institutional indicators are not equally important for foreign investors' decision-making process. Regulatory quality and government effectiveness stand out as more important than others in attracting FDI.

Since the economic system in former social countries suffered important institutional changes to be competitive on a world market for foreign investors, it enabled scholars to perform different analysis of institutional quality to determine the importance of institutional quality on the attraction of FDI.

Among the first researchers who analysed the institutional framework in transition countries were Holland and Pain (1996). They conducted panel data analysis of the factors that had an influence on the inflow of FDI in 8 Eastern European economies in the period from 1992 to 1996. Their results showed that together with macroeconomic determinants such as labour cost and trade openness, the method of privatization process plays an important role in the level of FDI inflow. They also found out that countries which are closer to the EU and have great trade linkage with the advanced economies are able to attract a higher level of FDI.

From Meyer's (2001a) perspective the institutional quality of transition economies is interesting to be explored because these countries altered their institutional framework in the 1990s. Their business environment changed from a command economy to a free-market economy. The institutional framework is characterized by the heritage of communism and by the need to construct business relations from scratch, including private ownership, the system of private property, capital markets and adequate legal and institutional infrastructure. Also, North (2005) added that institutional quality in transition countries has become a very popular matter to analyse since these countries represent a suitable base for analysis the influence of institutional quality improvements on the economic development of transition countries.

Pournarakis and Varsakelis (2002) analysed institutional quality through a panel data-set that they applied to 10 transitional countries of the CEE region from 1997 to 2000. They wanted to prove that institutional determinants like civil and political rights and corruption are crucial in explaining the decision making process of foreign investors when deciding where to invest their capital in transition countries during the 1990s. The conclusion was that weak civil and political rights in these countries prevent foreign investors to invest their capital. Moreover, they draw to close that transparent business environment in these countries would attract more FDI, especially those investors from countries who are members of the EU. The core of their policy should be the

development of strong political and civil institutions along with an efficient bureaucratic system.

Therefore Grosse and Trevino (2005) analysed to what extent stabilization and creation of a more favourable investment climate have effects on the level of FDI inflow. Their findings explained that corruption negatively affects the level of FDI inflow while the low level of capital repatriation and presence of Bilateral Investment Arrangements have positive impacts on the level of FDI inflow.

Fabry and Zeghni (2006) used European Bank for Research and Development (hereinafter: EBRD) transition indicators to analyse the main determinants of FDI inflows. EBRD indicators were used by many researchers in their studies due to their relevance to the issues of transition economies. They analysed 11 transition countries and their focus was on the type of ownership, reform of the banking sector, trade liberalization and legal development. The results showed that protection of property rights is one of the main determinants of FDI inflows due to the distrust of foreign investors regarding the expropriation issues. Except for the protection of property rights, the development of the private sector and the overall quality of regulatory framework significantly influence the foreign investors' decision where to invest. Moreover, these two researchers analysed the importance of EU membership in attracting FDI in transition countries. The results showed that foreign investors are more suspicious towards non-candidate countries than to existing EU members or future EU members. The reason for that is that candidate countries before joining the EU must improve their legal, political and economic institutions shifting to a more stable, transparent and quality institutional framework.

Slovenian researchers Sušjan, Kostevc and Redek (2007) were also among researchers who analysed the connection between FDI and the importance of institutional quality in transition countries. They divided their analysis into two phases. In the first phase, the Heritage Foundation data were used as indicators of institutional quality and showed that regulation, protection of property rights and the black market have the biggest impact on the level of FDI inflow. In the second phase, they conducted panel data analysis for 24 transition countries in the period from 1995 to 2005. The result of the panel data analysis revealed that institutional quality largely influences the level of FDI inflow. Other variables that foreign investors recognized as important were budget deficit, insider privatization and labour cost per hour.

Tintin (2010) also recognized the importance of EU membership in attracting FDI. Considering that 78% of total FDI comes from European investors, Tintin stated that is very important to include EU membership perspective determinant when analysing the level of FDI flow in a particular country. To become an EU member, a country must

improve their institutional framework according to the standards of the EU, such as economic freedom, political rights and civil liberties. The improvements of economic freedom directly influence the business and investment environment and therefore this variable can be seen as more important than others. After the study of Tintin, it can be assumed that the EU membership perspective determinant can be used as an important determinant when explaining FDI flow in CEE countries.

Estrin and Uvalić (2013) researched FDI trends in SEE countries during the first years of the 2000s and found out that increase in FDI inflow was based on minimal conditions such as renewal of peace and basic security in the country, economic recovery and improvement of the business environment. They also stressed the importance of market size, the abundance of natural and human resources on FDI inflows and found out that multinational companies are sensitive to the business environment and privatization strategy. Furthermore, they found out that conflict, political instability and delayed reforms reduced the level of FDI inflow in SEE countries.

Zeneli (2014) investigated the significance of the quality of institutions in attracting FDI in the SEE region employing the generalized method of moments econometric technique for the time frame 1992 - 2010. She found a clear connection between the quality of institutional framework and the attraction of FDI in this region. Development of new effective policies, reforms and implementation of those were considered more important than traditional variables such as market size, trade openness, exchange rate and labour cost for foreign investors when deciding where to invest their capital. She added that a stable political system, strong enforcement of laws, health monetary and fiscal policies and anticorruption measures tend to improve the level of FDI flow in SEE countries.

Dauti (2015) examined the main determinants of FDI and their influence on FDI inflow to five SEE countries and 10 new member countries of the EU. Data panel on bilateral FDI stocks were used for the period from 1994 to 2010, concentrating on market size, transaction cost and governance arrangements as the determinants of FDI. His research took into account specific institutional factors that affect the decisions of foreign investors from 20 OECD countries to invest in five SEE countries and 10 new member countries of the EU. From the obtained results they concluded that traditional determinants like market size and distance, institutional related determinants like control of corruption, corruption perception index, regulatory quality, transition progress and world trade organization membership influenced foreign investors' decisions while investing in SEE region and new EU member states. Also, Fazio and Talamo (2008) stated that regulatory quality enables easier entrance of foreign investors by eliminating unfriendly market policies like price controls, the intervention of



government and restrictions on the movement of capital and it is a very important indicator when analysing the level of FDI inflow.

Radulescu, Banica and Zamfiroiu (2016) conducted the econometric analysis using the VAR technique to explain that political-institutional factors, economic freedom factors and the quality of labour force influence the decisions of foreign investors when investing in Bulgaria and Romania. These two countries are characterized by a friendly business climate since they offer low-income taxes but they recorded large amounts of FDI only for a short period in the mid-2000s. The interesting fact is that authors found a positive correlation between regulatory quality and FDI inflow in Romania, but for Bulgaria, they didn't classify regulatory quality among other factors like the control of corruption the overall quality of infrastructure and the property rights index that influence FDI inflow.

Kurul and Yalta (2017) studied the connection between different institutional determinants and FDI flows for 113 developing countries from 2002 to 2012. They used panel data methodology and also analysed the effects of the global financial crisis in 2008-2009 on FDI flows. Their findings showed that not all institutional determinants are equally important in attracting FDI in developing countries. Government effectiveness, control of corruption, and voice and accountability were among the factors that influence FDI inflows the most. The reduction of corruption level and disproportionate burden of bureaucracy, progression of political systems and transparency and liability in government's representatives will result in a higher level of FDI inflows and greater confidence of multinational companies to invest in these countries.

## **4 EMPIRICAL ANALYSIS: THE IMPACT OF QUALITY OF THE REGULATION IN ATTRACTING FDI IN TRANSITION COUNTRIES**

This section is divided into three subsections. Subsection 4.1.1 describes the model and methodology which are used to prove the hypothesis that has been set in the introduction part of this master thesis. Subsection 4.1.2 gives the overview of variables used in analysis and their sources, while the last subsection 4.1.3 interprets the results of the research.

### **4.1 Model and Data Issues**

The empirical research refers to seven SEE transition countries marked as host countries *j*: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania and Serbia and eight trade partners marked as home countries *i*: Austria, Germany, Italy,

Netherlands, France, Slovenia, Switzerland and Turkey. The gathered data encompasses bilateral FDI stock between mentioned countries in the period from 2000 to 2015.

The variable of interest in this empirical research is the level of regulatory quality in the seven transition countries mentioned above. The necessary data for this variable were gathered from Worldwide Governance Indicators published by the World Bank.

The econometric model by which econometric analysis is performed is the gravity model. By using the gravity model, the aim of this empirical research is to analyse the relationship between the regulatory quality and FDI flows in seven SEE transition countries. So as to be able to better understand the gravity model, in the next subsection the theoretical background and use of the gravity model are going to be explained.

The gravity model is used in international economics to determine the measure of trade between two countries considering their economic sizes (GDP measurements) and distance between them. Chaney (2011) defined the gravity model as a standout among the most empirical findings in economic theory. He stated that bilateral trade between two different geographical entities is proportional to their respective sizes and inversely proportional to the geographic distance between them.

The gravity model of international trade finds its roots in the Universal Law of Gravitation developed by British scientist Isaac Newton in 1687. The Universal Law of Gravitation states that gravitational force between two objects  $i$  and  $j$  is directly proportional to the respective sizes of their masses while is inversely proportional to the square of the distance between them and is presented by the following equation:

$$F_{ij} = G \frac{M_i M_j}{D_{ij}^2} \quad (1)$$

where:

- $F_{ij}$  – refers to the gravity force,
- $G$  – refers to gravity constant,
- $M_i$  and  $M_j$  – refer to objects' masses,
- $D_{ij}$  – refers to the distance between two objects.

Taking into consideration Newton's law on gravitation, in 1962 Jan Tinbergen demonstrated that this law can be used in economic theory to explain the trade flows between countries. He was the first who enforced this law on international trade flow and is considered a discoverer of the law of gravity in the international trade economy. He expressed the law of gravity in international trade in the following way:

$$F_{ij} = G \frac{M_i M_j}{D_{ij}} \quad (2)$$

where:

- $F_{ij}$  – refers to the trade flow between two countries,
- $M_i$  and  $M_j$  – refer to the sizes of economies of countries included in exploration. In most cases GDP is used as indicator of economics' size,
- $D_{ij}$  – refers to the geographical distance between two countries.

By changing over Tinbergen's formula into a logarithmic equation and adding an error term, we will get a linear relationship called ordinary least square (OLS) regression analysis which is utilized for estimation of gravity models and is presented in the following way:

$$\log (F_{ij}) = \log G + \alpha \log (M_i) + \beta \log (M_j) - \gamma \log (D_{ij}) + \varepsilon_{ij} \quad (3)$$

We use the following econometric model in the empirical analysis:

$$\ln FDI_{ijt} = \beta_0 + \beta_1 \ln GDP_{it} + \beta_2 \ln GDP_{jt} + \beta_3 DIS_{ijt} + \beta_4 LC_{jt} + \beta_5 TO_{jt} + \beta_6 INF_{jt} + \beta_7 \ln RQ_{jt} + \varepsilon_i \quad (4)$$

where:

$FDI_{ijt}$  – denotes log FDI stock between home  $i$  and host countries  $j$  in period  $t$ ;  
 $GDP_{it}$  – denotes log of gross domestic product of home country  $i$  in the period  $t$ ;  
 $GDP_{jt}$  – denotes log of gross domestic product of host country  $i$  in the period  $t$ ;  
 $DIS_{ijt}$  – denotes log distance between capital cities of host and home countries;  
 $LC_{jt}$  – denotes relative unit labour cost of the host country  $j$  in the period  $t$ ;  
 $TO_{jt}$  – denotes exports and imports share in GDP of the country  $i$  in the period  $t$ ;  
 $INF_{jt}$  – denotes the inflation rate of the host country  $j$  in the period  $t$ ;  
 $RQ_{jt}$  – denotes the regulatory quality of the host country  $j$  in the period  $t$ ;  
 $\varepsilon_i$  – refers to error term.

## 4.2 Specification of the variables and Data Collection

As a dependent variable in econometric analysis, FDI has been characterized which represents the log of FDI stock between home and host countries expressed in EUR. There are some reasons why FDI stock data have been used in analysis rather than using FDI flows data. The first reason is that FDI flows vary throughout the observational period of time especially in transition countries, which is not characteristic for FDI stock which is measured at a given point in time. The second reason is connected with the proper functioning of the gravity equation. Since the logarithm only recognizes positive values, FDI stock data have been used instead of FDI flows data which values can be positive, negative or zero. The data for observed seven transition countries are

presented as the value of FDI stock between these countries and eight major trade partners in the period from 2000 to 2015.

Our variable of interest is the regulatory quality variable. As indicated by Kaufman, Kraay and Mastruzzi (2007), quality of regulation refers to the ability of the government to effectively formulate and enforce policies and regulations that enable and encourage private sector growth. Foreign investors perceive that good regulatory quality influences the stable business environment for investments. In the empirical literature, the regulatory quality was a subject of research in different studies such as in the studies by Shchegolev and Hayat (2018), Iwanow and Kirkpatrick (2007) and Freund and Bolaky (2006). According to the study of Shchegolev and Hayat (2018), regulatory quality influences the economic growth of countries. Furthermore, Freund and Bolaky (2006) claimed that strong regulatory quality contributes to the facilitation and volume of trade between different countries. Also, the study by Iwanow and Kirkpatrick (2007) revealed that regulatory quality positively influences the exports of the manufacturing sector. Their study showed that an increase of 10% in regulatory quality among all exporting countries influences exports of the manufacturing sector all over the world by nearly 10%. Moreover, Iwanow and Kirkpatrick (2007) stated that regulatory quality accelerates trade simplification across involved countries since it improves the government's functions and implementation and integration of government's policies. The quality of regulation of countries that are subject of econometric analysis is measured by Worldwide Governance Indicators published by the World Bank. Regulatory quality ranks from -2.5 to 2.5, where "-2.5" relates to the weak governance performance while "2.5" relates to strong governance performance. This variable showed to be significant for FDI attraction in the following explorations. Based on the hypothesis, which is set at the beginning of this master thesis, it is expected that this variable has a positive sign. That would mean that the host country's improvement in regulatory quality increases the amount of FDI inflow in that country.

If a country wants to attract worldwide companies it has to set up organized and well-governed institutions that will empower them to feel safe, stable and less risky on the host country's territory. Multinational companies don't like uncertain situations that arise from ineffective government's procedures, inadequate implementation of policies and regulations and insufficiently protection of property rights. Moreover, in attracting FDI and improving the country's economic growth, emphasis is placed on institutional efficiency. During the recent two decades, developed and transitioning countries have put great emphasis on institutional reforms to draw in more FDI. Generally speaking, strong institutional quality helps countries to easier attract FDI, while poor institutional quality discourages FDI.

In addition, a variety of control variables are included. In our model, we include market size which includes GDP of home country and GDP of the host country, trade openness, labour cost, macroeconomic stability and distance.

Market size is one of the major determinants of FDI inflow, found out by a lot of research papers on FDI's determinants, principally market seeking projects of FDI. The prevailing opinion is that bigger markets of the host country influence the greater inflow of FDI. Artige and Nicolini (2005) revealed that the size of the market measured by GDP or GDP per capita represents the most important determinant of FDI and it is characterized for horizontal FDI, while for vertical FDI is not relevant. Jordaan (2004) stated out that countries which have a large and expanding market with greater purchasing power can attract more FDI because investor there can obtain a higher return on their capital and generate higher profit from their investments. Petrović-Randelović, Janković-Milić and Kostadinović (2017) conducted multiple regression analysis to measure the effects of market size, market growth, trade openness and size of the population in attracting FDI in six countries of Western Balkan from 2007 to 2015. The presented results revealed that market size, market growth and size of the population had a positive impact on FDI inflow while trade openness had a negative influence on the attraction of FDI in six observed countries. Based on numerous analyses and studies on FDI determinants, the market size showed to be a significant determinant of FDI's attraction, and hence the relationship between the host country's GDP and FDI is expected to be positive. The data for this variable were collected from the World Bank database.

Trade openness represents a country's attitude to advocates or restricts trade between countries and it is considered as one of the most important factors of FDI inflow. The low trade openness can harm a country's economy thus contributing to slow economic growth and development. While on the other hand, the openness to trade with other countries contributes to greater economic development and growth. Quazi (2007) revealed that FDI inflow is highly associated with better infrastructure, higher return on investments and more trade openness. Also, he stated that there is a negative connection between FDI inflow on the one side and greater trade barriers on the other side. Moreover, Zenegnaw (2010) using empirical analysis proved that natural resources, labour quality and trade openness have a positive effect on the attraction of FDI. Nuno and Horacio (2010) analysed the contribution of market size, labour cost and trade openness on FDI flow into Portugal. They found out that market size and trade openness represent important factors in attracting FDI. Typically foreign investors are more oriented to countries that advocate trade between countries than to countries that have a low degree of trade openness. The data for this variable were also collected from the World Bank database and because FDI flows will be greater when countries are more open to international trade, This variable is supposed to have a positive sign.

By nature, multinational companies are attracted to locations that are characterized by lower labour and production costs. A high level of human capital represents a strong base for the existence of skilled workers, which along with cheap labour represents a strong host country's advantage for the attraction of FDI. A significant amount of studies have found a positive correlation between lower wages and differences in wage rates between home and host countries in attracting FDI. Therefore, lower labour and production costs in a host country have a positive impact on FDI flow. The lower costs of the workforce aim to decrease the production costs and maximize the profit of multinational companies, which makes a particular country a desirable location for foreign investors. The data for this variable were gathered from Statistical Database by the UNECE.

Macroeconomic stability represents important determinants of FDI especially when foreign investors want to protect their interests. As a measurement of macroeconomic stability, inflation is going to be used for econometric analysis. De Mello (1997) stated that a high level of inflation and interest rates can create an unfavourable economic situation in the country and therefore raise the cost of investments and influence the FDI's flow negatively. While on the other side, Asiedu (2006) and Ismail (2006) stated that a lower rate of inflation in a particular country influences higher FDI's inflow. Considering that a lower rate of inflation influences a higher inflow of FDI it is expected that this variable has a negative sign.

Usually, multinational enterprises will invest in countries that share some common characteristics as their home country. Referring to the sentence above, Dow and Ferencikova (2010) and Flores and Aguilera (2007) revealed that the greater the distance exists between home and host countries in cultural, administrative, political and geographic dimension it is more difficult for multinational enterprises from home country to operate and thus reduces the possibility for FDI to occur. As mentioned above there are four dimensions of distance that are accepted among scholars: cultural, administrative, political and geographic. For the econometric analysis in this master thesis, geographic distance is going to be used. Geographic distance represents the distance between capital cities of home and host countries. The greater geographic distance between home and host country's capital cities influences the increase of transportation and communication costs, the costs of transfer of staff to host country and the costs connected with the resolving of cultural, religious and regulatory differences. The geographic distance is expressed in kilometres and data for geographic distance were collected from the CEPII distance database. Based on the abovementioned facts it can be concluded that a high degree of distance in cultural, administration, political and geographic dimensions negatively affects FDI. Considering that FDI flows between home and host countries will be greater if administrative centres are closer to each other, it is expected that this variable has a negative sign.

Table 4 shows the review of variables used in empirical investigation and their main features.

*Table 4. Review of variables*

<b>Variable</b>	<b>Measure</b>	<b>Data Source</b>	<b>Abbreviation</b>	<b>Expected sign</b>
<i>DEPENDENT VARIABLE</i>				
Foreign Direct Investment	FDI stock in the host country	The Vienna Institute for Economic Studies (WIIW)	<i>FDI</i>	
<i>INDEPENDENT VARIABLE</i>				
Regulatory Quality	Level of regulatory quality in the host country	Worldwide Governance Indicators published by the World Bank	<i>RQ</i>	+
<i>CONTROL VARIABLES</i>				
Gross Domestic Product for home country	GDP of home country	World Bank	<i>GDPHOME</i>	+
Gross Domestic Product for host country	GDP of host country	World Bank	<i>GDPHOST</i>	+
Trade openness	Level of trade openness of host country	World Bank	<i>TO</i>	+
Labour cost	Gross Average Monthly Wage in host country	Statistical Database – United Nations Economic Commission for Europe – UNECE	<i>LC</i>	+
Inflation	Level of inflation rate in host country	International Monetary Fund – (IMF)	<i>INF</i>	-

*(table continues)*

(continued)

Distance	Distance between capital cities of home and host country	<i>DIS</i>	-
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Source: Own work

In table 5 the variables' descriptive statistics are presented.

Table 5. Descriptive statistics

Variable	N	Mean	Std. Dev.	Min	Max
<i>FDI stock</i>	834	1093.75	2107.355	.01	16099
<i>GDPHOME</i>	896	1.18e+12	1.09e+12	2.03e+10	3.87e+12
<i>GDPHOST</i>	896	4.06e+10	4.74e+10	3.63e+09	2.08e+11
<i>TO</i>	888	86.45416	17.91327	24.17033	134.5345
<i>LC</i>	744	572.3301	347.1169	69.5	1536
<i>INF</i>	896	5.507446	11.75829	- 2.167	111.959
<i>DIS</i>	896	1053.249	418.6105	117.3451	1875.018
<i>RQ</i>	896	.1294653	.3922121	-.8563468	.6973

In table 6 the variables' correlation matrix is presented.

Table 6. Correlation matrix

	<b>FDI stock ln</b>	<i>GDPHOMEln</i>	<i>GDPHOSTln</i>	<i>DISln</i>	<i>LCln</i>	<i>TOln</i>	<i>INFln</i>	<i>RQln</i>
<i>FDI stock ln</i>	1.0000							
<i>GDPHOMEln</i>	0.1946	1.0000						
<i>GDPHOSTln</i>	0.5605	0.0977	1.0000					
<i>DISln</i>	-0.0871	0.4841	-0.0192	1.0000				
<i>LCln</i>	0.3781	0.1498	0.4728	-0.2456	1.0000			
<i>TOln</i>	0.2206	0.0910	0.0712	0.0316	0.3613	1.0000		
<i>INFln</i>	-0.1939	-0.0715	-0.0274	0.0357	-0.4519	-0.4112	1.0000	
<i>RQln</i>	0.4492	0.1027	0.6010	0.0400	0.5541	0.3748	-0.3093	1.0000

Panel data refer to the repeated observations (usually years) of fixed units (usually countries). In this way, cross-sectional data on N spatial units and T time periods are combined to produce a set of data from N x T observations. When the cross-sectional units are more numerous than the time units (N>T), the data are dominant in cross-sections. In contrast, in the case when time units are more numerous than spatial ones (T>N), the data are called time dominant (Stimson, 1985).



Panel data analysis has recently gained importance for several reasons. The first reason is related to the problem of small “N” which has both time series analysis and cross-sectional analysis. Due to the limited number of spatial units and the limited number of available data over time, the data sets from these two techniques violate the basic assumptions of standard regression analysis. In small samples analyses which are a common case in studies, the total number of potential explanatory variables exceeds the number of degrees of freedom required to create the relationship between dependent and independent variables. In contrast, thanks to panel data, we can increase the number of observations and estimate models with a higher number of explanatory variables than is the case in analyses that use cross-sectional data and time-series data.

We started the analysis of panel data using the fixed effects (hereinafter: FE) estimation method. After the obtained result we applied diagnostic tests as follows: modified Wald test for heteroskedasticity in the FE model and Wooldridge test for autocorrelation in the panel data. The results of these tests indicate the presence of heteroskedasticity and autocorrelation in the estimated models.

In the context of this research, due to the presence of problems of heteroskedasticity and autocorrelation, we follow the recommendations set by Beck and Katz (1995) and use panel-corrected standard error (hereinafter: PCSEs). In addition, we apply the Prais-Winsten transformation model specifying autoregressive model (AR1) and the common rho for all cross-sectional units to take into account the serial correlation in the data. This technique was recommended by Plümper, Troeger and Manow (2005) as an estimation strategy that is more precise than models that use shifted dependent variables. In addition, the mentioned choice of estimation is based on the work of Achen (2000) in which it was shown that the shifted dependent variable "makes the estimated coefficients biased towards insignificant values and that it artificially overestimates the effect of the shifted dependent variable." The results of the PCSEs model are presented in the Prais-Winsten regression table.

### 4.3 Results

Table 7 presents the results of econometric analysis.

*Table 7. Results of Prais - Winsten regression*

Variable	Coefficient	Standard error	P - value
<i>GDPHOME</i>	0.48 ***	0.05	0.00
<i>GDPHOST</i>	- 2.71 ***	0.98	0.00
<i>DIS</i>	- 1.82 ***	0.16	0.00

*(table continues)*

(continued)

<i>LC</i>	3.20 ***	0.66	0.00
<i>TO</i>	0.00	0.00	0.21
<i>INF</i>	- 0.01 **	0.00	0.02
<i>RQ</i>	1.00 **	0.39	0.01
N	674		
R - squared	0.84		

Note: Dependent variable: Bilateral FDI stock between home and host country.

\*\*\* - significance at 1% level, \*\* - significance at 5% level

\* - significance at 10% level

In table 7 the results of the econometric analysis are presented. The results showed that the GDP home variable has a significant and positive impact on FDI inflows for 7 observed countries and it is significant at a 1% level. We find that host country market size proxied by GDP levels has significant impact on FDI flows across SEE countries. The obtained negative coefficient of this variable indicates that smaller countries of SEE region attract more FDI inflow. The distance variable has a negative sign and it is significant at the level of 5%, indicating that the smaller distance between countries results in higher FDI inflow which is in line with the gravity model hypothesis and previous findings. When countries are located nearby, it implies lower transaction and distribution costs which as a consequence attract a greater level of FDI inflow. The coefficient on labour cost is positive and significant at 1% level. The result shows that the labor costs have a positive and significant effect on FDI. This is perhaps because the skills of the labour force are expected to have an impact on decisions about FDI location. Furthermore, the choice of measurement for labour cost (without productivity) is not the best choice even though it has the most data availability. The inflation rate is statistically significant at a 5% level with a negative sign, indicating that countries with lower inflation rate and stable macroeconomic environment have a greater possibility for higher FDI inflows. This result is following the findings of many researchers. The trade openness variable is not found to be significant in the estimated model. Regarding the regulatory quality variable, which is also the main subject of this research, it has been shown that this variable has a positive sign and is significant at the level of 5%. The obtained coefficient for regulatory quality variable confirms the hypothesis set at the beginning which claims that quality of regulation has a positive and significant impact on FDI inflows in seven SEE transition countries. This means that an increase of regulatory quality in analysed countries of the SEE region influences the increase of FDI inflows in that country. It has been shown that the government's ability to formulate and enforce comprehensive policies and regulations that encourage and facilitate private sector growth influences the level of FDI inflows. The obtained results demonstrated the fact that institutional quality plays an important role when foreign investors are making decisions whether to invest in a particular country, considering its economic and industrial features.

## CONCLUSION

The main objective of this master thesis was to analyse the impact of regulatory quality on FDI flows from 2000 to 2015 in seven SEE transition countries. Together with this analysis, the definition and classification of FDI have been given. Also, current FDI trends in observed countries have been analysed to have a better insight into countries' ability to attract foreign capital in their markets. Countries like Macedonia, Serbia, Bulgaria and Romania are more preferable to foreign investors amongst others. These countries took a set of reforms such as the fight against corruption, low tax rates, low labour costs, etc. to improve the business climate and become attractive to foreign investors. On the other side, countries like Albania and Bosnia and Herzegovina and are still lagging in the implementation of reforms and as a result receiving less foreign investments.

Using the gravity model, we managed to prove that increase in the regulatory quality in seven SEE countries has positive and significant effects on FDI inflows in these countries. Conducting this analysis, we aspired to give a contribution to the existing literature in the context of the relationship between quality of regulation and FDI in SEE transition countries, since the previous researches have been mainly focused on macroeconomic indicators as the key determinants in attracting FDI in transition countries. Also, some propositions for the improvement of the regulations will be given regarding regulatory quality on FDI flow.

The findings obtained in the gravity model demonstrated that all variables are statistically significant except trade openness. The obtained results for GDP home variable is significant and has a positive effect on FDI inflows for observed countries. The distance variable coefficient has also shown to be negative and statistically significant, suggesting that when selecting locations to invest in, multinational corporations take this variable seriously into account. When investing abroad, they need to contemplate the costs of transport, the public infrastructure of the host country, cost of staff reallocation, communication costs, etc. The coefficient for the inflation rate also showed to be significant indicating that countries with lower inflation rate attract more FDI. Although many researchers highlighted trade openness as one of the most important determinants of FDI, in this investigation we didn't find this variable to be significant for FDI inflow in observed countries. Regarding the regulatory quality variable, we managed to prove that regulatory quality has a positive and significant impact on FDI inflows in observed countries. This means that the hypothesis set at the beginning has been proved and that the increase of regulatory quality in a particular country of SEE region results in the increase of FDI inflow in that country.

Some of the recommendations for the improvement of the regulatory quality are as follows:

- design regulations that are efficient and that they protect the general public, that is stick to the rights and obligations of investors and support the smooth functioning of the market;
- creation of regulations that strive to the openness of market which will provide a competitive advantage to host countries;
- liberalization of regulation and offer incentives to investors;
- establishment of strong judiciary institutions that will enable enforcement of contracts and effective resolution of commercial disputes;
- design regulations that limit state's power to expropriate private property in cases when private property is considered to be used for public use;
- take a series of structural, procedural and management reforms to establish an independent, efficient and professional court system;
- establish adequate regulations that protect the intellectual property rights of investors.

The contribution of this master thesis to the existing literature is that these findings can serve as an instrument to governments of SEE transition countries, to assess the role and effects of regulatory quality on FDI inflows. Also, as has already been mentioned this thesis aims to fill a gap in the existing literature regarding the main determinants of FDI that have an impact on foreign investors' decision-making process.

The recommendation for further investigation is that it would be interesting to conduct a more detailed investigation on a single specific transition country from the SEE region among these seven SEE transition countries. Also, including other worldwide governance indicators such as voice and accountability, political stability, government effectiveness, rule of law and control of corruption in econometric analysis and analysing their impact on FDI inflows would be challenging and interesting.

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## **APPENDICES**



## **APPENDIX 1: Povzetek v slovenščini**

Globalizacija svetovnega gospodarstva je prinesla ogromno povečanje obsega neposrednih tujih naložb v tranzicijskih državah, zato so te države vse bolj dostopne in usmerjene v tovrstne mednarodne tokove kapitala. Od začetka tranzicijskega procesa v vzhodni Evropi so bile neposredne tuje naložbe označene kot ključni dejavnik v procesu prestrukturiranja.

Glavni cilj magistrske naloge je bil analizirati vpliv kakovosti zakonodaje na pretoke neposrednih tujih naložb v letih 2000 do 2015 v sedmih tranzicijskih jugovzhodnih evropskih državah. Skupaj s to analizo je bila podana opredelitev in razvrstitev neposrednih tujih naložb. V raziskavi so bili analizirani trenutni trendi neposrednih tujih naložb v opazovanih državah, da bi dobili boljši vpogled v zmožnost držav, da privabijo na svoj trg tuji kapital. Pri tujih vlagateljih so med drugimi bolj zaželeni države Makedonija, Srbija, Bolgarija in Romunija. Te države so sprejele vrsto reform, kot so boj proti korupciji, nizke davčne stopnje, nizke stroške dela, ter mnoge druge, da bi s tem izboljšale poslovno klimo in postale privlačnejše za tuje vlagatelje. Na drugi strani pa so države, kot so Albanija, Bosna in Hercegovina in Hrvaška, ki še vedno zaostajajo pri izvajanju reform in zato posledično prejemajo manj tujih naložb.

Z uporabo gravitacijskega modela smo uspeli dokazati, da ima povečanje regulativne kakovosti v sedmih jugovzhodnih evropskih državah pozitivne in pomembne učinke na prilive neposrednih tujih naložb v te države. Pri tej analizi smo želeli prispevati k obstoječi literaturi v okviru razmerja med kakovostjo regulacije in neposrednimi tujimi naložbami v tranzicijskih jugovzhodnih evropskih državah, saj so bile prejšnje raziskave v glavnem osredotočene na makroekonomske kazalnike kot ključne dejavnike pri privabljanju neposrednih tujih naložb v tranziciji držav. Predloženi so tudi nekateri predlogi za izboljšanje zakonodaje v zvezi z regulativno kakovostjo pretoka neposrednih tujih naložb.

Ugotovitve pridobljene v gravitacijskem modelu so pokazale, da so vse spremenljivke statistično pomembne, razen spremenljivke odprtosti trgovine in stroškov dela, ki so se za opazovane države izkazale za statistično nepomembne. Dobljeni rezultati za BDP držav gostiteljic so pokazali, da države z večjimi trgi privabljajo več neposrednih tujih naložb zaradi izkoriščanja ekonomije obsega pri proizvodnji in prodaji izdelkov in storitev na trgih držav gostiteljic. Zato lahko trdimo, da so neposredne tuje naložbe v tranzicijskih državah večinoma tržno usmerjene. Kot pomembna ter pozitivna se je izkazala spremenljivka domačega BDP, ki vpliva na prilive neposrednih tujih naložb v opazovane države. Za negativnega in statistično pomembnega se je izkazal tudi spremenljiv koeficient razdalje, kar kaže na to, da multinacionalne družbe pri izbiri lokacij za vlaganje to spremenljivko resno upoštevajo. Pri naložbah v tujini morajo

upoštevati stroške prevoza, javno infrastrukturo države gostiteljice, stroške prerazporeditve osebja, stroške komunikacije itd. Tudi koeficient stopnje inflacije je bil pomemben, kar kaže na to, da države z nižjo stopnjo inflacije pritegnejo več neposrednih tujih naložb. Čeprav so številni raziskovalci izpostavili odprtost trgovine kot enega najpomembnejših dejavnikov neposrednih tujih naložb, v tej raziskavi nismo ugotovili, da je ta spremenljivka pomembna za priliv neposrednih tujih naložb v opazovane države. Glede na spremenljivke regulativne kakovosti smo uspeli dokazati, da ima regulativna kakovost pozitiven in pomemben vpliv na prilive neposrednih tujih naložb v opazovanih državah. To pomeni, da je bila hipoteza, zastavljena na začetku, dokazana in da povečanje kakovosti zakonodaje v posamezni državi jugovzhodne evropske regije povzroči povečanje priliva neposrednih tujih naložb v to državo.

Nekatera priporočila za izboljšanje regulativne kakovosti so:

- oblikovanje predpisov, ki so učinkoviti in varujejo splošno javnost, da se držijo pravic in obveznosti vlagateljev in podpirajo nemoteno delovanje trga;
- oblikovanje predpisov, ki stremijo k odprtosti trga, ki bo državam gostiteljicam zagotavljal konkurenčno prednost;
- liberalizacija predpisov in spodbujanje vlagateljev;
- vzpostavitev močnih sodnih institucij, ki bodo omogočale izvrševanje pogodb in učinkovito reševanje gospodarskih sporov;
- oblikovanje predpisov, ki omejujejo pristojnost države za razlastitev zasebne lastnine v primerih, ko se šteje, da se zasebna lastnina uporablja za javno uporabo;
- sprejemanje vrsto strukturnih, procesnih in upravnih reform za vzpostavitev neodvisnega, učinkovitega in profesionalnega sodnega sistema;
- oblikovanje ustreznih predpisov, ki ščitijo pravice intelektualne lastnine vlagateljev.

## APPENDIX 2: The results of Prais-Winsten regression

```

Group variable:  ID                      Number of obs   =      674
Time variable:  year                    Number of groups =      56
Panels:         correlated (unbalanced)  Obs per group: min =      6
Autocorrelation: panel-specific AR(1)          avg = 12.03571
Sigma computed by casewise selection          max =      15
Estimated covariances =      1596          R-squared        =      0.8480
Estimated autocorrelations =      56          Wald chi2(28)    =     8152.57
Estimated coefficients =      29          Prob > chi2      =
0.0000

```

	Panel-corrected					
FDIstocln	Coef.	Std. Err.	z	P> z	[95% Conf. Interval]	
GDPHOMEln	.4811574	.0564189	8.53	0.000	.3705783	.5917365
GDPhostWBln	-2.715444	.9837773	-2.76	0.006	-4.643612	-.7872763
distanceln	-1.828845	.1617437	-11.31	0.000	-2.145857	-1.511833
GrossAverageMonthlyWagesln	3.200888	.6632304	4.83	0.000	1.900981	4.500796
tradeopenesshostWB	.0053792	.0043176	1.25	0.213	-.0030832	.0138416
inflationendofperiodchangeIMF	-.0164108	.0071233	-2.30	0.021	-.0303722	-.0024493
RQ	1.002942	.3982979	2.52	0.012	.2222928	1.783592
hostcountrylabel						
2	4.10556	1.071321	3.83	0.000	2.005809	6.205311
3	1.527442	.9748319	1.57	0.117	-.3831933	3.438078
4	-1.768787	.6737316	-2.63	0.009	-3.089277	-.4482974
5	.7528985	.5212298	1.44	0.149	-.2686932	1.77449
7	6.075501	1.414231	4.30	0.000	3.303659	8.847343
8	9.816606	2.32844	4.22	0.000	5.252947	14.38027
year						
2001	.0155709	.0807832	0.19	0.847	-.1427614	.1739031

2002		.1613686	.1217898	1.32	0.185	-.077335	.4000722
2003		.4584675	.2292663	2.00	0.046	.0091138	.9078213
2004		.4970589	.3407651	1.46	0.145	-.1708285	1.164946
2005		1.076692	.4461178	2.41	0.016	.2023167	1.951066
2006		1.186802	.5021945	2.36	0.018	.2025186	2.171085
2007		1.279692	.6515641	1.96	0.050	.0026501	2.556734
2008		1.132981	.7554848	1.50	0.134	-.3477418	2.613704
2009		1.034208	.6417415	1.61	0.107	-.2235822	2.291998
2010		1.138749	.6407357	1.78	0.076	-.1170697	2.394568
2011		1.190061	.7082048	1.68	0.093	-.1979951	2.578117
2012		1.232179	.6723834	1.83	0.067	-.0856682	2.550026
2013		1.262461	.6990465	1.81	0.071	-.1076446	2.632567
2014		1.176236	.7091909	1.66	0.097	-.2137527	2.566224
2015		1.159876	.6378877	1.82	0.069	-.0903611	2.410113
_cons		45.65371	19.82752	2.30	0.021	6.792492	84.51493

rhos = 1 .7109747 .9186144 .9337353 .9897178 ... .5614532

. summarize FDIstockinthehostWIIWEUROS GDPHOMEWB GDPPostWB inflationendofperiodchangeIMF  
GrossAverageMonthlyWagesUS\_atcur tradeopenesshostWB distancebetweenecapitalcitieshome infl

Variable	Obs	Mean	Std. Dev.	Min	Max
FDIstockin~S	834	1093.75	2107.355	.01	16099
GDPHOMEWB	896	1.18e+12	1.09e+12	2.03e+10	3.87e+12
GDPPostWB	896	4.06e+10	4.74e+10	3.63e+09	2.08e+11
inflation~F	896	5.507446	11.75829	-2.167	111.959
GrossAvera~r	744	572.3301	347.1169	69.5	1536
tradeopene~B	888	86.45416	17.91327	24.17033	134.5345
distancebe~e	896	1053.249	418.6105	117.3451	1875.018
inflation~F	896	5.507446	11.75829	-2.167	111.959
RQ	896	.1294653	.3922121	-.8563468	.6973

```
. pwcorr FDIstocln GDPHOMEln GDPhostWBln distanceln GrossAverageMonthlyWagesln tradeopenesshostWB
inflationendofperiodchangeIMF RQ
```

```
| FDIsto~n GDPHOM~n GDPhos~n distan~n GrossA~n tradeo~B inflat~F~RQ
```

```
-----+-----
```

FDIstocln		1.0000										
GDPHOMEln		0.1946	1.0000									
GDPhostWBln		0.5605	0.0977	1.0000								
distanceln		-0.0871	0.4841	-0.0192	1.0000							
GrossAvera~n		0.3781	0.1498	0.4728	-0.2456	1.0000						
tradeopene~B		0.2206	0.0910	0.0712	0.0316	0.3613	1.0000					
inflatione~F		-0.1939	-0.0715	-0.0274	0.0357	-0.4519	-0.4112	1.0000				
RQ		0.4492	0.1027	0.6010	0.0400	0.5541	0.3748	-0.3093	1.0000			