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The Role of Institutions in Attracting Foreign Direct Investments

Kristina Maric and Miroljub Shukarov

South East European University, Str. Ilindenska, No. 335, 1000 Skopje, FYROM

Abstract

The aim of this paper is to identify the role of institutions in creating a prosperous business environment for attraction of the Foreign Direct Investments. This research is based on the statement that efficient markets depend on supporting institutions that can provide the formal and informal rules of the game of a market economy, allowing a lower transaction and information costs and reducing uncertainty. Moreover, it has to be stated that the legal and governmental arrangements as well as informal institutions underpinning an economy influence corporate strategies, thus profoundly influence the operation and performance of businesses. The methodology in this paper consists of comparing statistical data for the Balkan countries (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia, FYROM and Slovenia). The general conclusion drawn in this paper is that Western businesses entering countries with lower degree of institutional development face higher transaction costs such as bribery than in countries with higher degree of institutional development. Hence, the institutions play significant role in the process of one country's attempt to attract Foreign Direct Investment.

Keywords: Institutions, Institutional development, Foreign Direct investments

Corresponding Author: Kristina Maric; email: km22860@seeu.edu.mk

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1. Introduction

Institutions, their quality and level of development play a crucial role within one society's ability to develop, grow and promote economically stable environment. In this paper the term institution is used by the definition of [3], defining institutions as humanly invented constraints that structure political, economical and social interaction or simply as "rules of a game". Further on, the institutional framework is consisted of formal (policies, reforms, property rights etc) and informal rules (norms of behavior, self imposed code of conduct or in one term – social culture) and enforcement mechanisms. Having in mind that firms are generally keen to invest in countries which protect property rights, have a developed legal framework and enforced rules of law, provide well developed public services without burdensome bureaucracy and a redundant regulation or corruption, the paper chooses to examine the Balkan countries, as countries keen to attract foreign direct investments. Moreover, one of the reasons why the above mentioned set of countries is chosen in this paper is that one of their main goals to promote economic growth is through attracting foreign direct investments thus, increasing the level of exports and employment. Besides the increased level of exports and employment, the countries also gain particular know-how, new technologies and knowledge.

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There are studies in the literature investigate the relationship between the institutional development and foreign direct investments. Considering the work of North (1991), economic institutions establish the incentives faced by both the domestic and foreign economic agents. In that respect, institutional variables such as government policy [5], intellectual property rights protection [11] or political risk [6] have been considered as crucial in developing foreign business investment strategies.

Transition economies provide an interesting perspective to examine the impact of institution building because the entire set of formal institutions has been remodeled in the 1990s. The research in transition economies which started to analyze how institutions influence strategies by foreign investors shows the importance of institutional development, however only at an aggregate level [6, 10]. Furthermore, [4], by using comparative perspective, tend to explain the aspects of institutional development that provide a significant determinant of FDI receipts. Their results indicate a positive relationship between FDIs and the quality of formal institutions, though an impact from informal institutions can only be shown for the special case of Russia, which has suffered from a gap between the extensiveness and effectiveness of a legal reform. The findings by [4] indicate that several specific formal institutions are found to influence FDI such as private ownership of business, banking sector reform, foreign exchange and trade liberalization as well as legal development. Considering the transition countries, a research performed by [9], by using regression analysis determines the relationship between the institutional development and its importance in attracting FDIs in the Balkan countries. Varieties of variables included in the regression analysis show that GDP per capita and inflation has a positive impact on FDI inflows, while the institutional factors only corruption, large scale privatization, the development of trade and forex systems and overall infrastructure reform have a significant impact on FDIs inflow.

2. Institutions and FDI

Considering what is stated in the introductory part, the aim of the paper is to present the relationship between the institutional development and the way it impacts on FDI attractiveness. The group of countries chosen as representatives in this paper could be sub grouped in two parts, one group representing European Union member countries such as Slovenia, Croatia, Bulgaria and Romania and non European Union member countries such as FYROM, Albania, Serbia and Bosnia and Herzegovina. The examination period is within 11 years range, from 2004 till year 2014. For simplicity reason, the paper compares the Corruption Perception Index (CPI) as a representative institutional factor with the Foreign Direct Investment inflows for each country.

2.1. Corruption and FDI inflows

There is a wide research determining the relationship between corruption and FDI flows. Whilst some findings indicate that there is positive relationship between corruption and FDIs others reject and claim a negative relationship between the corruption and FDI inflows.

Investing in a foreign country with high level of corruption increases the cost of investment, since foreign investors have to pay extra costs in the form of bribes for example in order to get licenses or government permits to conduct investment [1]. Furthermore, corruption increases the level of uncertainty since corrupt actions cannot be enforced in the courts of law. However, according to some studies, corruption has a positive effect on FDIs. In economies with rigid regulation and highly inefficient bureaucracy, corruption might speed up the process of investing [2]. Nevertheless, this view of positive relationship between the corruption and FDI is empirically rejected. A study performed by [8], examining more than 2 000 firms claims that firms spent longer time negotiating in countries with high level of corruption. However, having in mind that the aim is to determine how the institutions impact the FDI inflows in a country, it has to be stated that corruption also depends on other institutional factors such as country's rule of law and economic freedom. [7], in his study indicates to the fact that in countries with weak rule of law, corruption has a positive effect on economic growth, whilst in countries with high institutional development it has a negative effect.

2.2. Comparing Data

In the below Table 1, it is obvious that the relationship between the CPI and FDI inflows is not necessarily positive. However, it has to be kept in mind that in the EU member countries the FDI inflows is based on policies and reforms as well as EU regulative for investment. For example, in Bulgaria and Romania from 2004 to 2007 there is a huge increase in the level of FDI Inflow, which is a period prior to their entrance in the European Union. The same effect it has with the CPI which tends to increase since their entrance in the EU, implying lowering the level of corruption perception. However, what is obvious is that the level of CPI changes whenever the country enters the European Union.

In Table 2 are the representatives of the Balkan countries which are non EU members, even though some of them are negotiating their entrance for a long period of time. The later statement implies that those countries such as FYROM and Serbia which have a status 'country candidate' for EU accession change and is obliged to implement different policies which will tend to increase their level of institutional development. However, from the below Table 2 it can be seen a trend in increasing FDI inflows with increasing the level of CPI (implying lower corruption).

However, it has to be stated that CPI is only one measure of institutional factors that affect the FDI attractiveness. There are other factors that could be concluded such the property rights, level of education which provides well trained and educated human capital, political risks, country's endowment to natural resources etc.

period											
indicator/country	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Slovenia											
FDI inflows (%GDP)	4,35	4,00	5,66	6,94	3,30	-7,80	1,24	0,65	-2,72	-1,06	3,05
GDP (% annual)	2,41	2,67	1,75	3,92	1,94	-0,69	0,66	1,71	0,07	0,22	2,08
CPI	6,00	6,10	6,40	6,60	6,70	6,60	6,40	5,90	6,10	5,70	5,80
Romania											
FDI inflows (%GDP)	8,45	6,89	9,27	6,00	6,65	2,94	1,91	1,38	1,53	2,01	1,94
GDP (% annual)	8,36	4,17	8,06	6,86	8,46	-7,07	-0,80	1,06	0,64	3,53	2,78
CPI	2,90	3,00	3,10	3,70	3,80	3,80	3,70	3,60	4,40	4,30	4,30
Croatia											
FDI inflows (%GDP)	2,59	3,95	6,54	7,60	7,36	5,10	2,39	2,27	2,57	1,61	6,89
GDP (% annual)	4,08	4,16	4,79	5,15	2,05	-7,38	-1,70	-0,28	-2,19	-1,06	-0,36
CPI	3,50	3,40	3,40	4,10	4,40	4,10	4,10	4,00	4,60	4,80	4,80
Bulgaria											
FDI inflows (%GDP)	10,20	13,74	22,95	31,00	18,84	7,52	2,49	3,69	3,34	3,58	3,48
GDP (% annual)	6,56	7,24	6,75	7,68	5,65	-4,22	0,05	1,58	0,24	1,28	1,55
CPI	4,10	4,00	4,00	4,10	3,60	3,80	3,60	3,30	4,10	4,10	4,30

Table 1: FDI inflows as percentage of GDP, GDP growth and CPI for EU Member Countries. Source: World Bank and Transparency International.

period											
indicator/country	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Albania											
FDI inflows (%GDP)	4,67	3,22	3,62	6,10	9,63	11,15	9,13	8,14	7,47	9,81	8,70
GDP growth (% annual)	5,71	5,72	5,43	5,90	7,53	3,35	3,71	2,55	1,42	1,11	2,17
CPI	2,50	2,40	2,60	2,90	3,40	3,20	3,30	3,10	3,30	3,10	3,30
Bosnia and Herzegovina											
FDI inflows (%GDP)	7,08	5,56	6,57	11,68	5,26	0,79	2,59	2,53	2,28	1,85	2,68
GDP growth (% annual)	6,10	8,76	5,38	5,73	5,48	-2,87	0,77	0,91	-0,93	2,39	1,08
CPI	3,10	2,90	2,90	3,30	3,20	3,00	3,20	3,20	4,20	4,20	3,90
FYROM											
FDI inflows (%GDP)	5,68	2,32	6,23	8,80	6,17	2,76	3,20	4,84	3,47	3,74	0,54
GDP growth (% annual)	4,67	4,72	5,14	6,47	5,47	-0,36	3,36	2,34	-0,46	2,67	3,77
CPI	2,70	2,70	2,70	3,30	3,60	3,80	4,10	3,90	4,30	4,40	4,50
Serbia											
FDI inflows (%GDP)	4,14	7,81	16,23	10,98	8,23	6,87	4,29	10,61	3,13	4,52	4,56
GDP growth (% annual)	9,05	5,54	4,90	5,89	5,37	-3,12	0,58	1,40	-1,02	2,57	-1,81
CPI	2,70	2,80	3,00	3,40	3,40	3,50	3,50	3,30	3,90	4,20	4,10

Table 2: FDI inflows as percentage of GDP, GDP growth and CPI for non-EU Member Countries. Source: World Bank and Transparency International.

3. Conclusion

The goal of the paper was to try to depict the relationship between the institutions, their development and how they impact in one countries' attractiveness for FDI. Through comparing the Corruption Perception Index of the selected Balkan countries the paper draw a basic conclusion that the level of corruption plays a role in the process of FDI attractiveness. However, in the countries that are already EU members, this trend could not be seen, considering that the reason is basically that these countries follow EU regulative and conduct policies which lead them to certain level of institutional development. The limitation of the study is that it provides one to one relationship between institutional development (and takes CPI as a proxy) and FDi inflows. As it was stated in the last part of the previous section, the FDI could be influenced by other factors, such as human capital, endowment of natural resource, rule of the law, property rights as well as the informal institutional factors such as one country's culture.

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