Quality of institutions, foreign direct investments and economic growth: empirical evidence from Balkan economies

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Abstract

This paper analyzes the relationship between institutions, foreign direct investment (FDI) and economic growth in the Western Balkans region. We use a difference-in-difference method to evaluate the impact of institutions on attracting FDI and promoting economic growth and we find evidence, which support that quality of institutions is an important policy variable. The research shows that institutions play a key role in determining economic growth and attracting foreign investment. This highlights the importance of creating and maintaining inclusive institutions that promote the rule of law, control of corruption, and regulatory quality, which can lead to increased economic development and investment.

Keywords: *Institutions, Foreign Direct Investment, Economic Growth, Western Balkans, European Union.*

1. Introduction

Foreign Direct Investment (FDI) has become a crucial factor in the development of economies worldwide. With globalization and the intensification of financial market links, the volume of FDI flow has increased significantly, reaching a total of $1.6 trillion in 2021 (World Investment Report, 2022), of which 837 billion were flowing to developing economies. Developing and transition economies have made attracting FDI a main objective of their domestic policies Mehic, Silajdzic, and Babic-Hodovic (2015) and engaged in a number of reforms to make it easier for foreign companies invest in their countries.

Attracting FDI as a tool to modernize the economy and push the country to a higher growth rate, requires a business environment which is friendly and conducive FDI is influenced by a complex set of variables, ranging from macroeconomic environment, quality of infrastructure, availability of required resources and quality of labor, taxation and bureaucracy, etc. In this paper, we will limit our analysis in exploring the role of institutions. Institutions have become a determining factor explain large country differences in the ability to attract more FDI and improve growth prospects.

The three countries included in this analysis are Albania, North Macedonia, and Croatia, and data ranges from 2000 to 2020. The institutional quality is measured using the institutional indicators designed by the Worldwide Governance Indicators (WGI). The paper follows with a (a) brief review of the existing literature on the topic of our research, (b) impact of EU integration on the quality of institutions of

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new member countries; (c) methodology and results of our work. We close with a discussion of the results and some policy implications.

2. Quality of institutions and FDI

Institutions have a significant impact on the attraction of foreign direct investment (FDI), making them a key area of interest for researchers. Numerous studies have been conducted to explore the relationship between institutions and FDI.

Daniele and Marani (2006) conducted a study of FDI inflows in 129 countries and found that the quality of institutions is an important factor in determining the inflow of FDI. This study used six indicators of institutional quality developed by Kaufmann, Kraay, and Mastruzzi (2010), as well as GDP growth and infrastructure, to analyze the relationship between FDI and institutional quality. The results showed that all variables related to institutional quality were significant in attracting FDI.

Quéré, Coupet, and Mayer (2007) conducted a study using data from the Institutional Profiles and the Fraser Institute's database to analyze the influence of institutions, such as bureaucracy, corruption, the banking sector, and legal institutions, on the flow of FDI. The results showed that these institutions, particularly bureaucracy, corruption, and the legal and banking systems, significantly impact the benefits of FDI.

Buchanan, Leb, and Rishi (2012) hypothesized that the poor quality of institutions increases the volatility of FDI inflows, which could harm economic growth. To test this hypothesis, they conducted an econometric analysis of a panel of data from 1996 to 2006 to understand the relationship between the quality of institutions and the volatility of FDI. The results showed that the quality of institutions has a positive and significant impact on FDI, and that a one standard deviation improvement in the quality of institutions could increase FDI by 1.69 times.

Minovic, Stevanovic, and Aleksic (2020) conducted a study of the Western Balkans 6 countries, excluding Kosovo, to analyze the relationship between institutional quality and FDI inflows. Using the VAR method, they found that political stability, control of corruption, and the rule of law were the key factors in attracting FDI. The results showed that a well-designed institutional environment creates a favorable business climate, which positively influences the flow and structure of FDI, while poorly designed laws and lack of transparency can significantly reduce the chances of attracting FDI

We are interested also in the relationship between quality of institutions and economic growth. Xhepa (2016) finds a strong relationship between some

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indicators of economic freedom and economic growth for the Balkan countries. While macroeconomic stability, stable trade and investment regimes, have been positively related to growth and welfare, high levels of corruption and low level of protection of property rights have been key impediments to enhancing growth prospects and welfare for the citizens.

In another paper focused more on the role of institutions and economic growth, Xhepa et al (2022) also find significant nexus between economic growth and good governance, which carries specifics to how the effect runs from the good governance to economic growth that are relevant for the country and time. Improving the control on corruption by 1 point would increase the economic growth rate by 0,06 percentage points; the rule of law and regulatory framework would strengthen the economic growth by respectively 0,004 and 0,07 percentage points, respectively.

In conclusion, numerous studies have confirmed that institutions play a crucial role in attracting FDI and promoting higher growth rates. Factors such as bureaucracy, corruption, the banking sector, legal institutions, political stability, control of corruption, and the rule of law have been found to have a significant impact on the flow of FDI and economic growth.

3. European integration and the impact on Institutional Quality

The general idea that dominates literature is that member states of European Union have high quality institution and therefore it can serve as a driving force for institutional improvements for the new member countries. Since the Treaty of Rome, democracy has been a condition for becoming part of the European Community. In principle, states seeking to become members of the European Community had as a prerequisite the existence of liberal democracies. Then this precondition was formalized with the Copenhagen Criteria which place special importance on the improvement of institutional quality, and compliance with EU institutions and legislation. The authors, Ostojić, Jovanović, and Petrović, (2019) consider the accession process as one of the most important stages in which European integration plays a role in improving institutional quality. According to these authors, referring to the data of the Heritage Foundation of 2018, thanks to the European integration process, the institutional situation in Serbia has improved recently, but to achieve results like those of the member countries, it is necessary to work constantly for their improvement.

Ekiert (2008) examines the impact that the EU accession process has on the consolidation of democracy, as well as the consequences of EU accession on the quality of the new democratic regimes in the Central and Eastern European states that have joined it. By consolidated democracy it means states which are

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characterized by “stable political institutions, the rule of law, compatibility and broader protection for political and civil rights, transparency and predictability of political processes” Ekiert (2008). He argues that the prospect of EU membership emerged as a powerful factor in shaping the internal and external policies pursued by political actors in the new European democracies. Consolidating democracy and building a market economy were the means for the candidate states to achieve this goal. On the other hand, the annual reports of the Commission have served to keep the balance of the institutional progress of these states following EU norms.

According to Penev and Marušić (nd), the EU accession process accelerated legislative reforms in the transition states of the Western Balkans, systematically contributing to the creation of a new legal system. As the transition process began in the Western Balkan states, their legal systems inherited from their socialist past were outdated in the provisions and concepts they contained. The implementation of the Acquis Communautaire as an important prerequisite for improving the quality of the regulatory environments of these states would aim to increase the competitiveness of their economies. According to these authors, in the last decade, the states of the region achieved significant improvements in the quality of laws, and this improvement was directly influenced by the progress of each of the states of the region in the EU membership process.

Schönfelder and Wagner (2016) also confirm that the prospect of countries joining the EU creates additional incentives for these countries to strengthen their economic and political institutions. The prospect of EU membership has important direct effects on voice and accountability, government effectiveness, and regulatory quality. For these authors, being a candidate country accelerates the development of government effectiveness and membership status contributes positively to voice and accountability. An important question they pose after proving the importance of the integration process in increasing institutional quality is what happens next to the quality of the institutions of these states when they have joined the EU and seek to become part of the eurozone.

Despite considerable heterogeneity among member states, Campos, Paris, and Moretti (2014), assert that there is strong evidence for positive gains in the institutional framework of EU membership. They take a synthetic counterfactual approach to see what would have happened to economic growth if the countries that joined the EU in 1973, 1980, 1995, and 2004 had not become part of it. Their results show that the per capita income in the absence of the process of economic and political integration would have been on average 12% lower today. They report significant and positive increases in GDP per capita after EU membership for all countries that joined the enlargement process except for Greece, which according to their results would have had higher incomes if it had not become a full member in 1981.

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In conclusion, the literature provides strong evidence that the European integration process has had a positive impact on institutional quality in EU member states. Through the accession process and the promotion of democracy, the EU has contributed to the improvement of economic, political, and legal institutions in these countries.

4. Data and methodology

The data used in this paper were extracted from the World Bank database. We have extracted a dataset for all three countries, i.e., Albania, North Macedonia, and Croatia. We used the six indicators developed by Kauffman, Kraay, and Mastruzzi (2010), which are: voice and accountability, political stability and absence of violence or terrorism, government effectiveness, regulatory quality, rule of law, control of corruption, as a depend variable we use FDI inflows (% of GDP).

In terms of economic growth, GDP per capita was used for each of these three countries, from 2000 to 2020. GDP per capita was originally downloaded from the World Bank in USD, however, to be consistent, we converted the GDP - per capita of each country into Euros using the average annual USD/Euro exchange rate. Therefore, we used a perfectly balanced data set in our empirical analysis. In our empirical analysis, we will use both continuous and dummy variables.

All variables are normally distributed with some degree of skewness or "kurtosis". We tried to improve the distribution of such skewed variables by logarithmically transforming them, but this does not help much given the nature of our data. Therefore, we will use our variables in levels and not logarithmically transform them.

We use the difference-in-difference (DiD) method to identify causal effects by comparing the change in outcomes before and after the intervention, for treatment and control groups. The group that underwent the intervention is considered the treatment group, while the group that did not undergo it is considered the control group. This method is mainly used when a new policy is applied, and its effects should be evaluated (Zhao, Rasool, Anwar, Zahra, (2021). The main idea of the DiD is that it evaluates the results separately for the control group and the treated group in the pre-and post-change period. Then, the difference between these two groups will be performed. The difference of difference is the effect produced by the treatment. In our case, as a control group, we have Albania and North Macedonia, and Croatia was taken as the treated group. This method will serve us to evaluate the effects that institutions have on FDI attraction and economic growth.

An important assumption here is that the trends are the same in both groups before the intervention and that the trends would be the same in both groups if

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the intervention had not taken part. This is otherwise known as the parallel trend's assumption This is an effect-identifying assumption, and treatment effects cannot be estimated if this assumption is violated, as DiD would provide biased estimates.

We will estimate two least squares (OLS), multiple linear regression models for panel data in our empirical analysis. We will follow a Difference in Differences approach in both of our models.

The first model is represented mathematically as:

$$\begin{aligned}\text{FDIinflowsofGD}P_{it} &= \beta_0 + \beta_1(time_{it}) + \beta_2(treatment_{it}) + \beta_3(did_{it}) \\ &+ \beta_4(VoiceandAccountability_{it}) + \beta_5(PoliticalStabilityandAbsence_{it}) \\ &+ \beta_6(GovernmentEffectiveness_{it}) + \beta_7(RegulatoryQuality_{it}) \\ &+ \beta_8(RuleofLaw_{it}) + \beta_9(ControlofCorruption_{it}) \\ &+ u_{it} \qquad (1)\end{aligned}$$

where FDI inflows (% of GDP) are the dependent variable, while voice and accountability, political stability and absence of violence or terrorism, government effectiveness, regulatory quality, rule of law, and control of corruption, i.e., the variables that show the quality of the institutions are the explanatory variables. We have also included the time term, the treatment term, and the difference-in-difference term in our model specification to analyze the difference in differences in FDI inflows (% of GDP) in the three countries after the integration of Croatia into the European Union.

The second model is represented mathematically as:

$$\begin{aligned}\text{GDPpercapita}_{\text{it}} &= \beta_0 + \beta_1(\text{time}_{\text{it}}) + \beta_2(\text{treatment}_{\text{it}}) + \beta_3(\text{did}_{\text{it}}) \\ &+ \beta_4(\text{VoiceandAccountability}_{\text{it}}) + \beta_5(\text{PoliticalStabilityandAbsence}_{\text{it}}) \\ &+ \beta_6(\text{GovernmentEffectiveness}_{\text{it}}) + \beta_7(\text{RegulatoryQuality}_{\text{it}}) \\ &+ \beta_8(\text{RuleofLaw}_{\text{it}}) + \beta_9(\text{ControlofCorruption}_{\text{it}}) + \text{u}_{\text{it}}(2)\end{aligned}$$

where everything is the same as in model 1, however, our dependent variable in this model specification is GDP per capita. We used the robust standard error pooled across countries to protect our panel data estimates from serial correlation or heteroscedasticity. Furthermore, there does not appear to be any problem with perfect multicollinearity in our data set as no variable can be perfectly predicted using a combination of two or more variables in our data set.

5. Discussion of the results

Table 1 and 2 show the results of the regression using FDI and economic growth as dependent variables and indicators of quality of institutions as independent variables.

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TABLE 1: Difference in Differences in FDI Inflows (% of GDP)

FDI Inflows (% of GDP)	Coef.	St. Err.	t-value	p-value	[95% Conf	Interval]	Sig
1 if Croatia included into the European Union, 0 otherwise	-1.738	.802	-2.17	.03	-3.31	-.166	**
1 if Croatia, 0 if Albania or North Macedonia	-5.042	4.206	-1.20	.231	-13.286	3.202	
Difference in Differences term	-.095	.933	-0.10	.919	-1.924	1.735	
Voice and Accountability	.095	.146	0.65	.515	-.19	.38	
Political Stability and Absence of Violence or Terrorism	.1	.065	1.55	.122	-.027	.226	
Government Effectiveness	.078	.089	0.88	.381	-.096	.252	
Regulatory Quality	.062	.076	0.82	.414	-.087	.211	
Rule of Law	-.099	.17	-0.58	.56	-.431	.234	
Control of Corruption	-.062	.049	-1.26	.207	-.159	.035	
Constant	-3.172	11.763	-0.27	.787	-26.228	19.883	
Mean dependent var		4.892	SD dependent var		2.708		
Overall r-squared		0.399	Number of obs.		60		
Chi-square		.	Prob > chi2		.		
R-squared within		0.138	R-squared between		0.992		

Robust standard errors clustered across States
**** p<.01, ** p<.05, * p<.1*

TABLE 2: Difference in Differences in GDP per capita (Euros)

GDP per capita (Euros)	Coef.	St. Err.	t-value	p-value	[95% Conf	Interval]	Sig
1 if Croatia included into the European Union, 0 otherwise	-650.3	1478.441	-0.44	.66	-3547.99	2247.39	
1 if Croatia, 0 if Albania or North Macedonia	4602.991	836.514	5.50	.000	2963.454	6242.529	***
Difference in Differences term	2617.709	975.612	2.68	.007	705.544	4529.874	***
Voice and Accountability	-68.89	105.629	-0.65	.514	-275.919	138.138	
Political Stability and Absence of Violence or Terrorism	27.507	40.003	0.69	.492	-50.899	105.912	
Government Effectiveness	-.392	19.786	-0.02	.984	-39.171	38.387	
Regulatory Quality	128.609	26.202	4.91	.000	77.254	179.965	***
Rule of Law	63.136	53.07	1.19	.234	-40.879	167.15	
Control of Corruption	-44.06	39.283	-1.12	.262	-121.053	32.934	
Constant	-2321.838	2675.754	-0.87	.386	-7566.22	2922.544	
Mean dependent var		5589.290	SD dependent var		3564.376		
Overall r-squared		0.960	Number of obs.		60		
Chi-square		.	Prob > chi2		.		
R-squared within		0.766	R-squared between		1.000		

Robust standard errors clustered across States
**** p<.01, ** p<.05, * p<.1*

The regression coefficient on the time dummy variable in model 1 is -1.738. This can be interpreted as the FDI inflows (% of GDP) in the 3 countries were 1.738% lower before Croatia's integration into the European Union as compared to after its integration, ceteris paribus. This regression coefficient is statistically significant at the Significance Levels of 5% and 10%, based on a p-value of 0.03.

Out of various indicators of the quality of institutions, the regulatory quality results to play a stronger role in explaining economic growth and attracting FDI.

6. Conclusions

Results of the regression confirm the strong relationship between institutions and economic growth. The regression coefficient for the treatment dummy variable in

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the economic growth model is high, confirming the impact of EU integration on the institutional improvements and their role on attracting higher levels of FDI and increase in GDP per capita.

Another important result from our regression analysis is that out of measures used to quality of institutions, Regulatory Quality plays a stronger role. The regression coefficient for this indicator in the economic growth model turns out to be 128. This shows that if the regulatory quality in a country improves by 1 unit, on average, we can expect the GDP per capita in that country to increase by 128 euros.

In terms of the relationship between institutions and foreign direct investment (FDI), the statistically significant coefficient was for the time dummy variable, which was -1.738%. This shows that FDI inflows were 1.738% lower in the three countries before the integration of Croatia into the EU. Although the literature suggests a positive relationship between EU integration and increased FDI, the coefficient for the Difference in Difference term in terms of FDI inflows was -0.095%, indicating that inflows were 0.095% lower in Croatia compared to Albania and North Macedonia. However, this result was not statistically significant at conventional levels of significance, so further research is needed to confirm these findings.

In conclusion, our research shows that institutions play a key role in determining economic growth and attracting foreign investment. This highlights the importance of creating and maintaining inclusive institutions that promote the rule of law, control of corruption, and regulatory quality, which can lead to increased economic development and investment.

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