# Foreign Direct Investments and Reforms in Albania (1998-2014)

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### Abstract

The main focus of this paper is the influence of Governmental reforms in attracting FDI. I conducted research on the 2006 Albanian Governmental reforms that were meant to attract FDI. Empirical estimation is done on time series data provided by the Bank of Albania and regression discontinuity is applied in order to estimate the total effect of the reforms. In this thesis I used two methods of estimation. GMM method showed to be superior to OLS as endogeneity issues made OLS biased. In the case of Albania the statistical results show a significant positive effect of such reforms in attracting FDI.

# **Table of Contents**

Acknowledgements	ii
Abstract	iii
List of Tables	v
List of Figures	vi
1. Introduction	1
2. Literature review	7
2.1 Overview	7
2.2 Eclectic Paradigm	8
3. Albanian Reforms and Marketing Process	
4. FDI Determinants and Data	12
5. Methodology and Results	14
5.1 Western Balkans	14
5.2 Effect of the Reforms	23
5.3 Albania without the Reforms	28
6. Conclusions	
Appendix	34
References	40

# List of Tables

Table 1 Countries and their Slogans	11
Table 2 World Bank Report	15
Table 3 Doing Business Report	16
Table 4 FDI - Western Balkans and Reforms	18
Table 5 FDI - Western Balkans and Reforms in Albania, Macedonia and Montenegro	20
Table 6 Results using OLS and GMM	25
Table 7 FDI Determinants up to 2006	28
Table 8 FDI - Western Balkans and Reforms (Macedonia Included)	34
Table 9 Variables Provided by Bank of Albania	37
Table 10 Results Using OLS and GMM (All Variables)	37

# List of Figures

Figure 1	Albania - FDI inflows	1
Figure 2	FDI in Western Balkans	3
Figure 3	Privatization and total FDI	4
Figure 4	FDI percentage in Albania, by County	13
Figure 5	Predicted FDI after 2006	30

#### 1. Introduction

Attracting FDI is at the top position in the priority list of policy makers as it is regarded, especially in developing countries, as a mixture of capital, technology and other practices such as marketing and management. There is an increasing genuine interest from policy makers on how to know what attracts foreign investments. It is important to know theoretically how these investments will take place as entering new markets and producing abroad bare extra costs for companies (Markusen, 1995). Many others believe that FDI is highly correlated with the implementations of structural reforms in reducing such costs. The positive progress of structural reforms can serve as a signaling tool to foreign investors, as these reforms generate real benefits in lowering the investment risk and affecting parameters that are crucial to investment decisions. Much work has been done, in different subfields of economic theory, but there is still no widely accepted consensus on an adequate model that provides the basis for the empirical work.

This paper takes into consideration the economic reforms of the Albania Government in 2006 and compares the FDI inflows before and after this year (Figure 1). These economic reforms were innovative as they introduced the concept of One-Stop-Shop, Albania One Euro, flat tax rate etc. to facilitate doing business in the country and lock in investors and firms.

Figure 1

Albania - FDI inflows



(Data collected from WIIW)

This study is also significant as previous researches show that FDI inflows are "path dependent"; they depend on previously accumulated capital stock (Hansson, Gari & Josefson, 2004) and such low investment level paths of FDI would only slightly increase over time. On the contrary, Albania can serve as an example to show that: (1) such paths can be redrawn by policymakers, and (2) attach high expectations to those instead. Yearly data collected from the Vienna Institute for International Economic Studies shows an increase by 556 Million Euros in FDI inflow the year after the government introduced the new policies to attract foreign direct investments.

To the best of my knowledge, there is no previous study aiming to investigate the impact of these economic reforms on FDI inflow levels in Albania; therefore the findings of this study will provide some initial insight on such unexplored issues for the country and beyond.

The benefits of FDI can be summarized as follow: FDI affects local employment, increases tax revenues and savings in the region, and is also associated with spillover effects which often are assumed to be one of the most important consequences. Coe and Helpman (1995), argue that using the channels of trade flow, an essential and undeniable booster for TFP has been documented to be cross-country R&D, which in developing areas is mainly a result of FDI in the region. Blomström and Kokko (1997) argue that foreign firms that would enter the new market through FDI will leak technology and information to home producers that will further use the comparative advantage that their country has to offer, or at least will promote growth at local enterprises.

In the Western Balkans, promoting and attracting foreign investments has been a backbone of every political campaign and all the countries have institutionalized their efforts by having their own National Investment Agencies (OECD, 2010). I can conclude that in the last decade most of the countries in the Western Balkans have experienced FDI, as a percentage of the GDP, higher than the average European Countries and this can be attributed, to some degree, to the success of this National Agencies of Development and Investments (Figure 2 – FDI expressed as percentage of GDP). Nonetheless, there is often skepticism from economists who just relate FDI inflows as being part of a large scale privatization strategy. Data, on the contrary, showed quite the opposite: most of the foreign direct investments in Albania were not associated with privatization (Figure 3).

#### Figure 2

FDI in Western Balkans



(Data Collected From WIIW : German Average 1.5%)

#### Figure 3





(Source: UNDP - FDI report Albania, 2010 p.20)

My aim is to investigate whether reforms taken by governments in the Western Balkans and Albania have played a crucial role in increasing foreign investment inflows. Many argue that the announcement of structural reforms has been seen as a positive signal to foreign investors. Still, putting the reforms into practice is fundamental to draw large foreign investment inflows in the home country. Nevertheless, reforms taken may differ between countries, and even in cases where they are highly similar their effects may still greatly differ.

For this reason, the main contribution of this paper is to measure the effectiveness of such reforms in the Western Balkans countries using panel yearly data, with an individual focus on Albania using time series quarterly data. Results from the Western Balkan countries, which were successful in introducing and implementing reforms, show an increase of around 6 percentage points in FDI (measured as a percentage of GDP). Indeed, Albania and Montenegro, which are considered to be successful in the implementation of these reforms, show an increase of 4 and 10 percentage points respectively. Meanwhile, Macedonia did not show any positive significant increases in FDI after the implementation of the reforms, possibly as a result of the hampered proper budget planning. This suggests that reforms alone were not enough in attracting FDI.

In addition, applying GMM and OLS to the Albanian case, I find that reforms implemented by the Albanian Government were successful in attracting FDI to the country, with a positive significant increase of around 500 million euros per year (or around 2.5 percentage points when FDI is measured as a percentage of GDP). Interestingly in the case of panel data, Albania shows an increase of 4 percentage points and in the case of time series data shows an increase on average of 2.5 percentage points. This discrepancy can potentially be explained by the fact that the time series data that I employ is quarterly data rather than yearly aggregated data. Nevertheless, I also conducted a prediction on FDI in the case that no

5

reforms were taken, and graphic representation clearly shows the positive change from the predicted and real values of FDI.

This thesis is organized as follow. In the second chapter I present an overview of the relevant literature, and discuss Dunning's Eclectic Paradigm. In the third chapter I present the Albanian reforms and the marketing process. And, in the fourth I present the FDI determinants from other authors and discuss the dataset. Then, in the fifth chapter: I conduct an empirical analysis of the effect of the reforms in the Western Balkans, I measure the effect of the reforms in Albania, using two different statistical methods, and I predict the FDI inflows if such reforms were never taken. In the sixth chapter the conclusions are discussed.

#### 2. Literature review

Foreign Direct Investments, according to the World Bank (2015), are "net inflows of investment to acquire a lasting management interest, 10 percent or more of voting stock, in an enterprise operating in an economy other than that of the investor." So FDI are investments made from country A to country B and they are "long lasting", which reflects the longstanding relationship of the investment and the investor. But the concept of FDI dates back to the times of Smith and Ricardo. However, the discipline itself was developed much later only as a general theory, and the determinants of FDI were not even mentioned in the studies. This is probably related to the fact that there were huge variations in the FDI of different sectors. Studies on the determinants of FDI came only later on with the valuable insights of Hymer (1976) Dunning (1976, 2001) and Vernon (1977, 1991).

#### 2.1 Overview

Nowadays the world, under the effect of globalization, has changed. It is a more dynamic environment than it used to be and the study on the Albanian reforms and macro-economic variables give us a better insight on the determinants of FDI inflows. The judgment taken by the economic agents nowadays faces more push and pulls factors, as well as more options in the decision making. Globalization, among the main factors, is believed to have influenced the factors of investing opportunities abroad; firms look carefully on efficiency, the market, resources and the long term strategy. Dunning (1988) was one of the first to take into account the pull and push factors, however he is mainly known to the world for his pull factors, the local determinants of FDI. Following Dunning, FDI is determined under pull and push factors. Pull factors have mainly to do with the home country, and in such cases low wages and relatively low tax rates make Albania and the Western Balkans an interesting investment opportunity. The push factors on the other hand, such as the crisis in Italy and Greece, are related to the source countries. According to Rogoff at al. (2007), these push factors are mainly related to business cycles and other economic macroeconomic variables of the source economy. According to the author, such factors are imperative in the intensity and flow of foreign investments.

One should not also forget that developing countries are more prone to the volatility of FDI, or to sudden stoppages of it. The labor force is highly connected to the inflow of foreign funds, and it is mostly accepted that GDP has an impact on FDI volatility too. Loayza at al. (2007) conclude that growth in developing countries is more volatile than others as they greatly depend on inflow of foreign funds. Shocks in developing countries have more consequences to the economy as these countries have lower absorbing potential. Nevertheless, even source countries can be hurt as FDI outflows are highly simultaneous to expansions in new markets, and logically to an increase in sales (Van Pottelsberghe de la Potterie and Lichtenberg 2001). Finally, Lensink and Morrissey's (2006) article suggest a negative impact of FDI volatility on economic growth.

#### 2.2 Eclectic Paradigm

Dunning's eclectic paradigm of international production was first introduced in 1976, at a Nobel Symposium. Dunning (1988) built a comprehensive theory in trying to explain the increase in the foreign production based on the monopolistic theory from Hyner and the factor endowment theory from Heckscher and Ohlin. Built on his personal judgment that FDI can be only explained from different fields of economics, Dunning's (1976) theory is mainly constructed in three columns: "owner specific advantages, location specific advantages and internalizations advantages" (OLI).

According to Dunning, the only way a foreign firm can compete with the domestic ones, is to have comparative advantage over them. As foreign firms face sunk costs to set up the production, the comparative advantages should compensate first of all for the costs bared and face the home competition. Many call these monopolistic advantages, but Dunning calls them "owner specific advantages". The second issue is related to the fact that these firms, which are entering a new foreign country, should couple their home comparative advantage with the local ones, which for many are a burden, in order to overcome the disadvantages faced from the foreign production. The most important advantages from the host country can be human capital, natural resources, low wages, tax heavens or other governmental regulations. Last but not least, according to Dunning, were the issues related to internalization advantages, on ability of the firm to make use of the economies of scale, or even patenting their production in the domestic market. Nevertheless, despite the knowledge and expertise of the foreign company, there is a high degree of uncertainty in such possibilities. However, the most important feature of OLI says that is better to have two soldiers fighting while watching each other's back, rather than on their own, economically speaking: "comparative advantages value more when all added up together, rather than one by one" (Dunning, 2001).

#### **3. Albanian Reforms and Marketing Process**

Reforms taken by the Government were first introduced to the public in 2006, and were later fully implemented in 2007. Many officials of the time argue that the reforms were determinant in bringing a new wave of Foreign Direct Investments. Such reforms had to do with flat tax reduction to ten percent, reduction of customs and tariffs, free economic zones, facilitation of Fiscal administration, minimization of the number of licenses etc. They also add that "Albania-One-Euro" was the main structural change.

"Albania-One-Euro" was a way to attract foreign investors; state owned land could be rented out for only one Euro a month and a business license would cost just one Euro in cases of foreign investments that would be relatively big in value, One-Stop-Shop (business registration, license, tax number etc. at one location), reduction of the timing needed to open up a business. Registering a business takes only one day and it costs 1 euro. Also the steps needed to open up a business have been reduced from 10 to 5. (Full list of the reforms in the Appendix)

In addition, when you couple all the structural reforms with increased political stability, with the country entering the NATO Alliance and getting the Potential Candidate Statues to the EU, played a positive role in attracting foreign investors.

Also, it is necessary to understand that besides having made a lot of reforms; more or less it is also a process of marketing. In the following Table I provide the marketing slogans of some the European countries. Marketing is quite important in attracting FDI and these entire countries look like they are competing like Pepsi and Coca-Cola.

#### Table 1

#### Countries and their Slogans

Country /	Slogans used by National Investment Agencies
Region	
Albania	"Albania One Euro"
Italy	"Log on to Italy"
Germany	"Land of Ideas"
Ireland	"Knowledge is in our nature"
Sweden	"New Ways of Thinking"
Czech Republic	"The Skills Hub of Central Europe"
UK	"Want to be part of the UK cutting-edge technological revolution?"

Many of these countries (Table 1) are building their image as Research and Development (R&D) locations. Similarly, in the process of international visibility, they heavily invest in the marketing of new R&D intensive projects. Behind the marketing process, these countries follow an innovation policy, which focuses on targeting and attracting only R&D concentrated FDI. One should not forget that the above mentioned countries, except Albania, are economically developed. On the contrary, Albania as a developing country in great need of FDI never had the luxury to have a policy in welcoming only R&D concentrated investments. Yet, in the absence of R&D hubs, it was trying to attract intensive FDI investments, which might also have been R&D focused, by offering to investors' low taxes and friendly business environment. To conclude this chapter, according to Krugman (1997), investment decisions are made upon the following properties: "imitation, clustering and demonstration effects" or "herd behavior".

#### 4. FDI Determinants and Data

The general feeling is that FDI is more important for the development and growth of the country than other inflows, because statistics shows FDI to be less volatile than other variables (IMF, World Economic Outlook, 2007). Alfaro (2003) argues that depending on the country and its macro-economic factors, FDI indeed is better for growth; still there are skeptics who do not believe in that FDI is better for growth since some sporadic empirical evidence contradicts that.

I follow Walsh and Yu (2010) with some of the reason why foreign investors want to invest in a host country and to check whether these macro determinants of FDI hold in the case of Albania. In addition to macro-economic determinants, some say that FDI is closely related to economic stability, potential and size of the market, quality of institutions, development levels and openness (Walsh and Yu, 2010).

Moosa at al. (2006) argues that market, with GDP as a proxy, as a market hypothesis and the real exchange rate are of great importance for investors to make decisions. Frenkel at al. (2004) argue that GDP growth is one of the main factors for FDI inflow. Bevan and Estrin (2004) on the other hand show that the unit labor cost is of great significance. According to Resmini (2000), the large inflow of FDI in Central and Eastern Europe in the 90's, came as a result of the respective trade openness. Nonnemberg and Mendonça (2004) show that inflation as an important variable of economic performance is determinant in FDI attraction. Uygur (2005) on the other hand, argues that budget deficits and interest rates, as economic stability variables, do affect FDI decisions. Campos and Kinoshita (2003) show that agglomeration and clustering play a great role in attracting FDI. Data from Bank of Albania shows that actually there was agglomeration as a factor towards attracting FDI in Albania; this mainly can be explained from the service and lightweight industry around the capital

12

Tirana (Figure 4), where Tirana has received 55% of all FDI in the country so far, making it a hot spot for foreign investments.

#### Figure 4





(Source: Bank of Albania)

CEU eTD Collection

In the next chapter I calculate the effectiveness of such reforms in attracting FDI. In order to perform my empirical analysis, data was collected from the Central Bank of Albania and the World Bank. Bank of Albania has provided data, quarterly, starting from 1996 to 2014, for the macro-economic determinants of FDI (Full list in the Appendix). In addition, yearly data starting from 1992 to 2013, for all the Western Balkans countries was collected from the World Bank. Yet, there are some data limitations such as in the case of Kosovo.

#### 5. Methodology and Results

I take into account macroeconomic factors such as tax levels, minimal wage, capital stock, banking sector etc. that foreign investors might have found to be crucial in deciding to invest in Albania. Yet, the main variable of interest is a dummy variable that represents the reforms, and it takes the value of one after 2006. This variable is crucial into measuring the effect of the reforms.

Nevertheless, first I construct a panel data model, to see the effect and significance of similar reforms in the countries of the Western Balkans. Results from the region, show an increase of 6 percentage points on average in FDI (measured as percentage of GDP), and an increase of 4 percentage points for Albania. Second, I measure the effect of these reforms using the data provided from the Bank of Albania using Ordinary Least Squares and Generalized Method of Moments (endogeneity issues made OLS biased). Results show an increase of 2.5 percentage points on average, that when compared with the average of the region, Montenegro (around 10 percentage points increase), and the results from the first model for Albania, are lower. This discrepancy can be possibly explained with the facts: (1) data is aggregated in the first model, (2) different structural reforms were implemented and (3) Montenegro experienced a boom in tourism and construction. Third, I perform a prediction for FDI to compare the fitted and real values if such reforms were never taken.

#### 5.1 Western Balkans

Before focusing in Albania, I do take a look at the structure of FDI in the Western Balkans. For that I followed Artige and Nicolini (2006), who do take into consideration three European regions and the macro-economic determinants of FDI for these three regions. The regions that they chose, rely on a combination of factors that makes them different, similarly, the six countries in the Western Balkans are quite different, economically and socially speaking. We have Croatia, already a member of the European Union, followed by the candidate states, Albania, Macedonia and Serbia, and lastly, the potential candidates, Bosnia and Kosovo. Going back to Artige and Nicolini, data might be missing in some years, and for cases like Kosovo, there exists data only for some periods. So, due to data limitations, some of the variables from the authors, like percentage of GDP spent for education, have been dropped out.

From the region I take into consideration three countries for their reforms; first is Macedonia, which did improve and facilitate the tax administration system, and improved registration for opening a business (Table 8 which includes Macedonia can be found in Appendix). The second is Albania that resulted being efficient in the business environment, lowering the income and corporate tax, and introducing "One-stop-shop". Montenegro attracted FDI by reducing the "red-tape" (excessive bureaucracy), introducing a new constitution in 2007, new banking laws following Basel II and new scheme of voluntary contributions. My choice also depends on the report from European Commission: *The Western Balkan in Transition* (2009) and World's Bank *Doing Business Report* for this region with a threshold of being ranked under 94 which is the average of the region, where these three countries were ranked under 90 (Table 2 & 3).

#### Table 2

World Bank Report

COUNTRY	Docur to exp (numi	nents ort oer)	Time t export (days	to t )	Cost to (US\$ p contair	) export )er her)	Docu to im (num)	ments port ber)	Time to (days)	import	Cost to (US\$ p contair	import er ier)
	2006	2014	2006	2014	2006	2014	2006	2014	2006	2014	2006	2014
Albania	7	7	21	19	818	745	8	8	22	18	820	730
Bosnia and Herz.	6	8	23	16	1170	1260	7	8	25	13	1150	1200
Croatia	7	7	26	18	1200	1335	7	7	18	15	1200	1185
FYR Macedonia	7	6	17	12	1130	1376	9	8	15	11	1130	1380
Kosovo		8		15		1775		7		15		1810
Montenegro		6		14		985		5		14		985
Serbia	6	6	33	12	1240	1455	7	7	46	15	1540	1760
High-income OECD		4		11		1070		4		10		1090

#### Table 3

#### Doing Business Report

#### World Bank - Doing Business Survey (2009, global risks (1)) simple TIYR Bosnia and Serbia Croatia Albania Montenegro average Macedonia Herzegovina WB Ease of Doing Business Starting a Business Dealing with construction permits Employing Workers **Registering Property** Getting Credit Protecting Investors Paying Taxes **Trading Across Borders** Enforcing Contracts **Closing a Business**

(1) from 1 (best performer) to 181 (worst performer)

Source: The rankings are from the Doing Business 2009 report, covering the period April 2007 to June 2008.

The remaining countries, according to the European Commission, did overall positively by introducing reforms; nevertheless these reforms were hampered by other problems. In the case of Bosnia and Herzegovina administrative inefficiencies in the entry and exit into the market, resulted being negative in attracting FDI, even though there were improvements in the company registration. In Kosovo the problems were mainly related to finance access and red-tape, while legislation resulted in being unfavorable in the case of market entry. In

Serbia, commercial courts and non-qualified administration has resulted in delaying business procedures. Other issues in Serbia regard the complex and bureaucratic legislation in entering the market. Croatia, in mid-2006, launched a project to identify and eliminate the unnecessary procedures, but its banking system was prone to credit risks from the foreign market. Nevertheless, all these countries suffer from the nonexistence of a well-developed private sector, which result in the internal markets being not highly competitive. Adding to that, public companies usually have proven to end up with considerable losses, becoming a burden for public finances.

I construct a panel data with data collected from the World Bank and I use time and individual fixed effects as I believe that the disturbances are not independent from the individual effects and that it helps into modeling FDI inflow evolution in time. It is also important to see that the reforms from these three countries in the region would result being efficient in attracting FDI. I decided to use FDI as a percentage of GDP as it is easier to comprehend the real changes, where  $\varepsilon_{it}+\mu_{it}$  is the individual and disturbance error. I follow a model in which most of the variables are derived from the work of Artige and Nicolini (2006), and other variables are neglected due to the lack of data. The main points of interest are the reforms followed by the countries from the region. In addition, lagged values are added and robust standard errors are used to account for any autocorrelation in the disturbances. Equation 1 and 2 differ, as the first measures the effect of the reforms for each country specifically. The baseline econometrical models are as follow:

#### Equation 1

 $FDI\_GDPit = \alpha + \beta IGDPPCit + \beta 2GDPPC\_1it + \beta 3Exportsit + \beta 4Exports\_1it + \beta 5GFCFit + \beta 6GFCF\_1it + \beta 7Reforms Albania Montenegrot + \beta 8i.t. + \varepsilon_{it} + \mu_{it}$ 

#### Note

- GDPPC Gross Domestic Product per Capita
- GFCF Gross fixed capital formation
- FDI\_GDP FDI measured as a percentage of GDP
- Reforms\_Albania\_Montenegro The effect of the reforms in both of the countries.

REFORMS =  $\begin{cases} y *= 1 & if \ y \ge 2007 \\ y *= 0 & if \ y < 2007 \end{cases}$ 

- Exports – Exports of the country in the given year

#### Table 4

FDI - Western Balkans and Reforms

Equation 2

*FDI GDPit* =  $\alpha + \beta I GDPPCit + \beta 2 GDPPC_1it + \beta 3 Exportsit + \beta 4 Exports_1it + \beta 5 GFCFit$ 

+  $\beta$ 6*GFCF\_1it* +  $\beta$ 7*Reforms\_Albaniat* +  $\beta$ 8*Reforms\_Macedoniat* + +

 $\beta$ 9*Reforms\_Montenegrot* +  $\beta$ 10*i*.*t*+ $\varepsilon$ *it*+ $\mu$ *it* 

#### Dependent Variable:

# FDI Measured as Percentage of GDP

	(1)	(2)	(3)
GDPPC	0.0004	-0.001	-0.0013
	(.0007)	(.0014)	(.0015)
GDPPC_1	-0.0006	0.0017	0.002
	(0.0007)	(0.0012)	(.0017)
GFCF		9.75*10 <sup>-10**</sup>	8.99*10 <sup>-10*</sup>
		(3.79*10 <sup>-10</sup> )	$(4.29*10^{-10})$
GFCF_1		-1.50*10 <sup>-9</sup>	-1.44*10 <sup>-9*</sup>
		(8.56*10 <sup>-10</sup> )	(6.3*10 <sup>-10</sup> )
Exports			2.88*10 <sup>-10</sup>
			(6.62*10 <sup>-10</sup> )
Exports_1			-1.91*10 <sup>-10</sup>
			(6.05*10 <sup>-10</sup> )
Reforms Albania	6.9**	6.42***	6.71**
Montenegro	(2.53)	(1.36)	(1.85)
	N = 114	N = 111	N = 110

**Time and Individual Fixed Effects** 

Note: \*,\*\*,\*\*\* are 10%, 5% and 1% confidence interval (error terms in brackets)

#### Note:

- GDPPC – Gross Domestic Product per Capita

- GFCF Gross fixed capital formation
- FDI\_GDP FDI measured as a percentage of GDP

- Reforms\_Albania The effect of the reforms in both of the countries
- Reforms\_Macedonia The effect of the reforms in Macedonia
- Reforms\_Montenegro The effect of the reforms in Montenegro
- Exports Exports of the country in the given year

REFORMS =  $\begin{cases} y *= 1 & if \ y \ge 2007 \\ y *= 0 & if \ y < 2007 \end{cases}$  - Effect measured separately

#### Table 5

FDI – Western Balkans and Reforms in Albania, Macedonia and Montenegro

#### Dependent Variable:

T DI Micusurea as i creentage of ODI	FDI Measured	as	Percentage	of	GDP
--------------------------------------	--------------	----	------------	----	-----

	(1)	(2)	(3)
GDPPC	-0.00006	-0.001	-0.002
	(.0006)	(.001)	(.001)
GDPPC_1	-0.0006	0.001	0.001
	(.0006)	(.001)	(.001)
GFCF		1.79*10 <sup>-9***</sup>	1.05*10 <sup>-9**</sup>
		(3.12*10 <sup>-10</sup> )	(3.87*10 <sup>-10</sup> )
GFCF_1		-1.24*10 <sup>-9</sup>	-1.28*10 <sup>-9</sup>
		(9.81*10 <sup>-10</sup> )	(7.36*10 <sup>-10</sup> )

Exports			3.11*10 <sup>-10</sup>
			(5.78*10 <sup>-10</sup> )
Exports_1			-2.95*10 <sup>-10</sup>
			(6.33*10 <sup>-10</sup> )
Reforms Albania	3.48**	4.06**	4.99**
	(1.36)	(1.32)	(1.45)
Reforms Macedonia	-1.36	-0.69	-0.08
	(1.49)	(1.95)	(1.68)
Reforms Montonogra	10.62***	10.57**	12.22**
wontenegro	(0.99)	(3.96)	(4.4)
	N = 114	N = 111	N = 110

#### **Time and Individual Fixed Effect**

Note: \*,\*\*,\*\*\* are 10%, 5% and 1% confidence interval (error terms in

brackets)

#### (Data collected from World Bank)

The main variable of interest from Table 4 is: *Reforms\_Albania\_Montenegro*. This variable measured on average the effect of the reforms on the two neighboring countries (Albania and Montenegro). In addition this variable demonstrated that if other countries would have followed the same path in introducing and implementing reforms, and their economies were not hampered by other issues, e.g. financial sector, they would on average had expected an

increase of 6+% on FDI. Furthermore, these economies were the only ones in the region that were hit less severely from the financial crisis.

On the other hand, the main variables of interest in Table 5 are: *Reforms\_Albania*, *Reforms\_Macedonia* and *Reforms\_Montenegro*. These variables are used to measure the effect of the reforms in each country individually. We can clearly see from Table 5 that the only countries in which the reforms have had a positive and highly significant effect are Albania and Montenegro. Even though Macedonia has been seen as successful into the continuation of reforms, FDI inflow sometimes shows negative values, while it does not show any statistical significance and in all cases is smaller than the neighboring countries.

Montenegro in the meantime shows a high degree of FDI inflow (around 1.2B US\$), more than double when compared to Albania (around 500M US\$). The following reasons may justify this difference: first, Montenegro uses Euro as its legal mean of exchange, protecting it from any currency instability, and second, Montenegro experienced a boom in the tourist industry and high external demand for real estate, where #1 investors are from Russia (European Commission, 2009). This might also explain the difference between the FDI inflow, after the implementation and continuation of reforms, between the coastal countries, such as Albania and Montenegro, and inland countries (Macedonia). The blue tourism industry might has been seen as an important target for foreign investors. This explains even the development and employment of coastal and inland parts of Montenegro, a positive difference of 13.4 percentage points between the coast and the north of the country.

The other reason for attracting FDI can be related to the development of the financial sector, where firms in these markets show higher growth rates, with Montenegro having one of the most developed financial sectors in the region, leaving Macedonia to the last place with the least developed financial sector, together with Bosnia and Herzegovina (World Bank, 2008).

22

In addition, Macedonia suffered from proper budget planning and low quality of public finance, which resulted from the country's main focus on short term spending rather than priority setting.

During this period, Albania and Montenegro were also more cost efficient in cases of imports and exports; they are the only countries in the region who have less than 1000\$ cost for import and export of a container. One would have expected higher values of FDI inflows for both countries, if the region was not hit by the world financial crisis in the third quarter of 2008. Nevertheless, these three countries were the only ones that merely showed a slight decrease in FDI with the beginning of the crisis.

#### 5.2 Effect of the Reforms

I continue by regressing the following equation, where the main variable of interest is, once more, the reforms taken by the government, and where the left hand side variable is the FDI as a percentage of GDP (Equation 3):

#### Equation 3:

 $FDI\_GDPt = \alpha + \beta 1Reforms + \beta 2tax\_level + \beta 3tax\_level\_1 + \beta 4REER + \beta 5REER\_1 + \beta 6GDPPC + \beta 7GDPPC\_1 + \beta 8Avarage\_Wage + \beta 9Avarage\_Wage\_1 + \beta 7Inflation + \beta 8Inflation\_1 + \beta 9Banking\_Assets + \beta 10Banking\_Assets\_1 + \beta 11Exports + \beta 12Exports\_1 + \beta 13GDPPCGROWTH + \beta 14GDPPCGROWTH\_1 + \varepsilon t$ 

#### Note:

- FDI\_GDP Foreign Direct Investment measure as a percentage of Gross Domestic
  Product
- GDPPC Gross Domestic Product per Capita
- Tax Level Taxation Level in that given quarter
- REER Real Exchange Rate
- Average\_Wage Average wage in the given quarter
- Inflation Inflation in the given quarter
- Banking\_Assets Banking assets in the given quarter
- GDPPCGROWTH Gross Domestic Product per Capita Growth
- Exports Exports of the country in that given quarter

- REFORMS = 
$$\begin{cases} y *= 1 & \text{if } y \ge 2007 \\ y *= 0 & \text{if } y < 2007 \end{cases}$$

I performed unit root tests before carrying out the regressions, and I found unit roots in the case of Inflation, the GDP per capita growth, and most of the first differenced variables. These indicated that inflation and GDP per capita growth are not stationary, showing (1) that the Central Bank of Albania does not have a target inflation, even though they have attempted to keep inflation around the 2% value, and (2) that economic growth, as Campbell and Mankiw (1987) advocate, follows the unit root hypothesis.

There might be multicollinearity between some of these variables, and following other practitioners, I first took into consideration the main variable of interest Reforms, and GDP per capita (as a proxy for market size), afterwards I added the other qualitative and macroeconomic determinants as presented below.

I carried out the regression via Ordinary Least Squares regression, with robust standard errors, since the Breusch-Pagan test indicated that there is heteroskedasticity present (implying that the errors or disturbances did not have the same variance across all the observations). In addition, I used GMM estimation, as it is a well-known concern that we might encounter potential endogeneity of some of the regressors while trying to determine FDI, and the use of Ordinary Least Squares would result in upward biased estimation; there is also a high chance of the error term being correlated with the independent variable. More specifically, when measuring FDI inflows in a country and the macroeconomic variables that are listed below, and when GDP per capita, GDP growth and REER (real exchange rate) are included, endogeneity concerns are present. To address such concerns, GMM estimation goes a long way in taking care of such issues.

Naturally, when trying to implement GMM the question of the instruments arises. For this reason I used lagged variables and differences as a choice of instruments. Arellano and Bond (1991) suggest that in cases of endogeneity, in addition to differences, the use of lagged variables is advised. Likewise, being a superior approach to the usage of only differences, I added additional lagged variables to the first and second differences as instruments, as differences alone might be weak instruments.

All the results presented in Table 6 were calculated using the Newey-West weighting matrix of autocovariances, and it solved the issue of positive definiteness of an autocovariance robust estimator. This estimator attempts to overcome autocorrelation and heteroskedasticity in the error terms in calculating my main variable of interest *Reforms* (Table 6 and Appendix – Table 10).

#### Dependent Variable:

#### FDI Measured as Percentage of GDP

	OLS R	obust	GMM Newey West			
	(1)	(2)	(3)	(1)	(2)	(3)
FDI_GDP_1	0.16	0.02	-0.04	0.22*	0.09	0.002
	(0.12)	(0.11)	(0.13)	(0.11)	(0.09)	(0.09)
Reforms	4.17***	2.43**	2.16	3.72***	2.27***	2.48***
	(0.77)	(1.02)	(1.47)	(0.5)	(0.65)	(0.67)
<b>R</b> -squared	0.58	0.63	0.67	0.58	0.62	0.65
N	62	62	61	62	62	61

Note: \*,\*\*,\*\*\* are 10%, 5% and 1% confidence interval (error terms in brackets)

To ensure that my model was correctly estimated, I focused on the test of over-identifying restrictions, provided by the Hansen J-statistics, in testing the hypothesis that the model is not overidentified; all the three models in the GMM passed the test, implying that they were correctly specified.

As I explained above OLS might be biased when trying to estimate my model as endogeneity issues can arise. We can see that when comparing the two tables (Appendix - Table 10), OLS and GMM, the first may be upward biased when it comes to determine the factors of FDI, and the second seems to give more efficient unbiased estimates. Nevertheless, my main

variable of interest is strongly positive and significant, giving great support to my hypothesis that the reforms undertaken by the government were successful in attracting FDI.

In both methods (Table 6), except OLS model 3, reforms show to have played a strong positive role, by increasing FDI inflow from 2 to 4 percentages points of GDP. In model 1 OLS and model 1 GMM, FDI turned out to have had the biggest effect of 4.17 and 3.72 percentage points respectively, which suggests that after the reforms were implemented, there was an increase in FDI inflow of around 4 percentage points of GDP. In model 2 OLS, after the inclusion of GDPPC (Gross Domestic Product per Capita) as a proxy for the market size, the effect of the reforms was an increase of 2.43 percentage points of GDP and it also revealed a positive significant effect of GDPPC, indicating that also market size is an important determinant for attracting FDI. Meanwhile, model 2 GMM showed a positive and significant effect of the reforms (2.27 percentage points), but it did not demonstrate any significant effect of GDPPC in attracting FDI.

In the third model OLS and GMM, I included all macro-economic variables that previous studies and authors showed to have an effect on FDI. Model 3 OLS did not show any significance of the reforms in attracting FDI, but it did show positive significance between average wage and FDI (Appendix – Table 10); and as expected it also showed a negative impact of taxes on FDI. On the contrary, the third GMM model revealed that the reforms had a positive significant effect of 2.48 percentage points. Additionally, the tax level was negative and significant, implying that a reduction in taxes was successful in attracting FDI.

A surprising finding was the negative and significant correlation between Banking Assets, GDP growth and FDI, which can be mainly explained from the 2009 financial crisis that hit the banking sector and economy, once it started to experience a huge inflow in FDI. Most interesting from model 3 GMM was the significance of the exports variable, showing a

27

positive significance between exports and FDI. This might be connected to the fact that a part of the new investors in Albania were actually aiming towards the foreign markets, instead of the home one. Nonetheless, I conclude that the economic reforms have had quite a huge effect. While, this paper helped to gain some more insight on the issue, a more detailed and thorough study is left to be carried out in the future, focusing more on the industry level.

#### 5.3 Albania without the Reforms

It is important to know what would have happened had no reforms been undertaken in 2007. This is how would the forecast of FDI have been in 2006, in such case that the government would have not really planned to undertake any reforms to attract FDI and foreign companies? For this purpose I follow Bellak et al. (2008), who suggest the following variables be included, after they provide a survey of empirical studies for Central and Eastern Europe (Equation 4):

#### Equation 4

 $FDI_{t} = \alpha + \beta IFDI_{1t} + \beta 2RealGDP_{t} + \beta 3RealGDP_{1t} + \beta 4Inflation_{t} + \beta 5Inflation_{1t} + \beta 6AvgWage_{t} + \beta 7AvgWage_{1t} + \beta 8BankingAsssets_{t} + \beta 9BankingAsssets_{1t} + \varepsilon_{t}$ 

This widely accepted model of FDI macro determinants allowed me calculate the expected FDI as of 1998 to 2006, and to compare it with the real values starting from 2007 (Table 7 & Figure 5).

Table 7 FDI Determinants up to 2006

Dependent Variable:

#### FDI (Million ALL)

Regressor	Estimated coefficients
Constant	-1778
	(3944)
FDI_1	-0.008
	(0.14)
Inflation	157.42
	(297)
Inflation_1	-153.81
	(198)
Average Wage	0.57
	(0.65)
Average Wage_1	-0.35
	(0.42)
Banking Assets	0.07
	(0.05)
Banking Assets_1	-0.082
	(0.07)
Real GDP	0.03
	(0.02)
Real GDP_1	-0.006
	(0.02)
Number of observations	34
R-squared	0.38
	Method Used
	Robust Least Squared

After performing the above regressions, I forecasted the expected FDI as of the fourth quarter 2006, for the upcoming years, and I do fit the real values that I have obtained from the Bank of Albania (Figure 5):

#### Figure 5



#### Predicted FDI after 2006

As we can see from Figure #5, it is quite clear that the forecast and the actual line, do appear to be quite the same for the period up to the fourth quarter of 2006, but after that year, the year that the reforms where initiated, the two lines appear to be far apart from each other. So this Figure is crucial in understanding the importance and positive effect of the reforms.

#### 6. Conclusions

Governmental reforms have been introduced in the developing economies since the late 80's or early 90's, as a policy to attract and bring foreign currencies inflows. One of the main components of capital inflows is FDI. Due to the large distinction between countries, the reforms taken and the variation in time, previous literature is more focused on general accepted variables (such as market size) and channels of FDI. The introduction and implementation of structural reforms will improve the business environment, resulting in better investment conditions and positive inflow of FDI.

In this study I examined the main macro-economic drivers of FDI, and also took into account the Governmental reforms of the Albanian Government in the year 2006. This study helps to shed some light on what attracts FDI in a developing small economy like the Albanian. In the first part I presented the Governmental Reforms. In particular I focused on the Governmental reforms and also observed the weight of the privatizations taken by the government at the time as to make sure that all this inflow of FDI was not a part of a huge privatization initiative, rather a success of the reforms.

During my research, I firstly constructed a panel model taking into consideration the entire region and measuring the effect of the reforms in three neighboring countries. From this model I can conclude that even though governmental reforms did play a role in attracting FDI, not all the countries were influenced the same way. The insignificant statistics results on the governmental reform from Macedonia, showed that not all the countries from the region were affected. This may be due to the small size of the reforms taken and that the other countries maybe attracted more investors in the tourism industry. On the other hand

31

Montenegro showed more than double the effect when compared to Albania; this mainly can be attributed to the boom in construction and a better developed tourism industry.

Secondly, I ran regressions using two different techniques (OLS and GMM) and concluded that the Albanian governmental reforms had a huge weight with regard to FDI inflows, more precisely around 2 to 3 percentage points increase when measured as a percentage of GDP or around 500 million US\$ (constant 2005 US\$). When it comes to the other macro-economic factors, some of the variables like banking assets and GDP growth, third model GMM, showed negative correlation, mainly because the country suffered from the financial crisis while experiencing an increase in FDI. Meanwhile, lowering taxes showed a positive effect in attracting FDI. Yet, in the third GMM model, exports were significant and positively correlated with FDI; I would add that FDI in Albania might be export oriented, rather than oriented to the home market.

Thirdly, I forecasted FDI in the year of the reforms, to measure and compare FDI inflows between real and fitted values, where fitted values show FDI inflows in case reforms were not taken and real values show the contrary. This helped to create an early idea, figuratively, of the positive effect of the reforms.

The lack of data prevented me from doing, deeper analysis on industry type. It would have been very important to understand the effects of the reforms on the industry scale. For example the Italian textile and leather industry is spread around the region of Tirana, forming a cluster in shoe and clothes production. Ideally, having data on county levels and industry type would have helped me identify more potential FDI determinants for the economy. (In this case, such other determinants are somehow hidden or not possible to observe as the data is aggregated to all industry types and regions.)

32

The strong impact of the Government reforms in 2006-2007 for attracting Foreign Direct Investments did help the Albanian economy. At the time, Klaus Schwab (Info Arkiva, 2008), the President of the World Economic Forum, called the reforms a history of success, but more work needed be done in order to keep up with the pace, so that the inflow of capital would not fall but grow. The new government in 2014 raised the tax on corporations, from 10 to 15%, that might hurt the other invest mentors in the future, making them to start looking for other countries. Some believe that this might have been used as a lock in effect.

There is more research to be done as one can further deepen the analysis by checking the long term relationship between reforms, FDI inflows and growth. Secondly, my findings can be compared if they hold for other developing countries of the region and beyond. And lastly, structural changes and reforms can be split into components (e.g. openness to trade, business climate indicator) and the effect of every component measured individually.

# Appendix

#### Table 8 FDI - Western Balkans and Reforms (Macedonia included)

# Dependent Variable:

# FDI Measured as Percentage of GDP

	(1)	(2)	(3)
GDPPC	0.0005	-0.0009	-0.0011
	(.0008)	(.0014)	(.0013)
GDPPC_1	-0.0005	0.0019	0.0025
	(0.0007)	(0.0013)	(.0017)
GFCF		9.89*10 <sup>-10**</sup>	9.47*10 <sup>-10*</sup>
		(3.46*10 <sup>-10</sup> )	$(4.25*10^{-10})$
GFCF_1		-1.65*10 <sup>-10</sup>	-1.23*10 <sup>-9</sup>
		(1.04*10 <sup>-10</sup> )	(6.93*10 <sup>-10</sup> )
Exports			$1.78*10^{-10}$
			(5.75*10 <sup>-10</sup> )
Exports_1			-6.4*10 <sup>-10</sup>
			(7.95*10 <sup>-10</sup> )
<b>Reforms Albania</b>	4.4	3.88*	3.42
Macedonia Montenegro	(3.0)	(1.88)	(2.68)
	N = 114	N = 114	N = 110

#### List of reforms

#### **Fiscal Reforms**

- 1- Flat rate tax of 10% instead of Progressive taxation
- 2- Reduction of tax on corporations and reconciliation with the rate of income tax of 10% (only applied in 2008)
- 3- Reduction of the rate of social contributions
- 4- Average tax applied on wages 29.1% (health insurance, social security etc. included) rather than 41.9% that is was in year 2000
- 5- Reduction of customs tariffs with countries in the region
- 6- Reduction of the number of national taxes
- 7- Decentralization of some taxes from the national to the local
- 8- Reduction of tariffs or tax levels on small businesses
- 9- Facilitation of fiscal administrative procedures

#### Structural Reforms

- 1- Minimization of the number of licenses required
- 2- One-Stop-Shop, reduction of the timing needed to open up a business. Registering a business takes only one day and it costs 1 euro. Also the steps needed to open up a business have been reduced from 10 to 5 days.
- 3- Unification of National Inspectorates

- 4- Albania One Euro, state owned land could be rented out for only one Euro and a business license would cost just one Euro in cases of Foreign Investments that would be relatively big in value
- 5- New Law on Concessions in the spheres of Energy, Agriculture etc.
- 6- New Law on Foreign Investment protection, adapted with the "acquiscommunitare"
  Law of the European Union
- 7- Promotion of Agricultural Land and Products, such as Olives, Orchards, Nuts and other Herbal Medicines
- 8- Progress in Law Enforcement
- 9- Creation of eight specific industrial and one free of choice areas exempted for 5 years from taxes (it was never implied, the new government is focusing on the implementation right now)

#### **Political Stability**

- 1- Membership in NATO
- 2- Status of Candidate in the European Union

Central Bank of Albania has provided data, quarterly, starting from 1996 to 2014, for the following variables (Table 9):

Table 9 Variables Provided by Bank of Albania

FDI Inflow	Nominal GDP
Real GDP	Nominal Exports
<b>Real Effective Exchange Rate</b>	Banking Assets
<b>Consumer Price Index</b>	Inflation
Minimal Wage	Average Wage
Tax Level	

Table 10 Results Using OLS and GMM (All Variables)

# Dependent Variable:

#### FDI Measured as Percentage of GDP

OLC Daharat			CMM Norres Word			
OLS Robust			GMM Newey West			
	(1)	(2)	(3)	(1)	(2)	(3)
FDI_GDP_1	0.16	0.02	-0.04	0.22*	0.09	0.002
	(0.12)	(0.11)	(0.13)	(0.11)	(0.09)	(0.09)
Reforms	4.17***	2.43**	2.16	3.72***	2.27***	2.48***
	(0.77)	(1.02)	(1 /17)	(0.5)	(0.65)	(0.67)
	(0.77)	(1.02)	(1.47)	(0.5)	(0.05)	(0.07)
GDPPC		0.46*	0.83		0.26	1.15
		(0.26)	(1.07)		(0.22)	(0.78)
GDPPC_1		0.18	-1.65		0.34	-2**

	(0.27)	(1.28)	(0.2)	(0.78)
Tax Level		-0.42*		-0.35***
		(0.24)		(0.13)
Tax Level_1		0.19		0.16
		(0.2)		(0.11)
REER		0.02		0.06
		(0.14)		(0.07)
REER_1		0.005		-0.05
		(0.11)		(0.07)
AVG_WAGE		0.0004*		0.0003
		(0.0002)		(0.0002)
AVG_WAGE_1		-0.0001		-9*10^(-5)
		(0.0002)		(0.0001)
Inflation		-0.12		-0.1
		(0.18)		(0.15)
Inflation_1		-0.02		-0.006
		(0.16)		(0.15)
Bank_Assets		1.88*10^(-5)		1.2*10^(-5)

			(2*10^(-5))			(1.05*10^(-5))
Bank_Assets_1			-2.73*10^(-5)			-2.18*10^(-5)*
			(2.08*10^(-5))			(1.09*10^(-5))
Exports			1.85*10^(-5)			9.24*10^(-6)**
			(4.32*10^(-5))			(3.67*10^(-5))
Exports_1			1.01*10^(-5)			4.56*10^(-5)**
			(4.49*10^(-5))			(4.51*10^(-5))
GDP Growth			-5.75			-9.89*
			(0.44)			(5.17)
GDP Growth_1			2.51			2.02
			(2.51)			(1.57)
Constant term	2.23***	-1.85	7.33	1.99***	0.25	9.53
	(0.42)	(1.58)	(7.67)	(0.23)	(1.67)	(6.31)
<b>R</b> -squared	0.58	0.63	0.67	0.58	0.62	0.65
Ν	62	62	61	62	62	61

# Note: \*,\*\*,\*\*\* are 10%, 5% and 1% confidence interval (error terms in brackets)

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