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Economic and Political Determinants of Foreign Direct Investment in the Western Balkans

A közvetlen külföldi befektetések gazdasági és politikai meghatározói a Nyugat-Balkánon

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Abstract: The Western Balkan countries are small, open economies with the aspiration of joining the European Union (EU). As they are in the process of transforming from centrally planned to market economies, they must rely on foreign direct investment (FDI) to bring in new technology, know-how, capital, and new jobs. These countries can attract investment, as they are stable, diverse economies with a prospective for EU membership; they share borders with the EU and offer favourable taxes, low labour costs, and incentives for investors. Starting a business in the region differs among the countries. Kosovo is the most favourable country, while Bosnia and Herzegovina has the longest, most complicated, and expensive process of starting a business. However, these countries are more corrupt than the EU average, with a less efficient judiciary system. The Western Balkan region is burdened by its history, which affects their relations. One of the latest examples is Kosovo's imposition of 100% tariffs on goods imported from Bosnia and Herzegovina and Serbia. Political instability discourages investors from coming to the region and encourages the population to migrate to the EU.

Összefoglaló: *A nyugat-balkáni országok kicsi, nyitott gazdaságok, melyek csatlakozni kívánnak az EU-hoz. Mivel ezen országok tervgazdaságokból próbálnak átállni a piacgazdasági berendezkedésre, külföldi tőkebefektetésekre van szükségük, hogy új technológiát, know-how-t, és tőkét hozzanak be, és hogy új munkahelyeket teremtsenek. Az országok befektetéseket vonzhatnak, mivel stabil, változatos gazdaságok uniós tagsági perspektívával, határosak az EU-val, kedvező adókat, alacsony munkaerőköltséget, és egyéb ösztönzőket kínálnak a befektetőknek. Az országok között eltér az üzletkezdés módja. Koszovóban a legkedvezőbbek a feltételek, míg Bosznia-Hercegovinában a legbonyolultabb, leghosszadalmasabb és legköltségesebb egy vállalkozás elindítása. Ezen országokban az EU-hoz képest nagyobb a korrupció, és kevésbé hatékony az igazságszolgáltatás. A nyugat-balkáni régiót terhelő történelem kihat az országok közötti kapcsolatokra. A legutóbbi példák egyike a Koszovó által kivetett 100 százalékos vám a Bosznia-Hercegovinából és Szerbiából érkező termékekre. A politikai instabilitás elriasztja a befektetőket és ösztönzi a lakosság elvándorlását.*

Introduction

The Western Balkan countries - Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia - are small open economies that have been going through the transition from centrally planned to market economy for almost twenty-five years. They are considered to be the next group to join the European Union and the transition process will end once the countries become EU Member States.

The centrally planned system was characterized by the state ownership of companies, restricted trade, non-existent investment, and controlled prices, which were artificially low or high and were not determined according to the law of demand and supply.

Even though the centrally planned system was more flexible in Yugoslavia than in other Central and Eastern European (CEE) countries, the CEE countries joined the European Union in 2004, 2007, and 2013. Most of these countries had finished their transition process in less than 15 years.

Then why does it take so long for the Western Balkan region to go through the transition process? One reason is that the countries were at war in the 1990s, which destroyed their economies and intra-regional relations. The region is catching-up to the EU, as their per capita GDP growth is higher than the EU average. In order to become full members, the Western Balkan countries have to assimilate their development level with that of the EU, and in this sense they are lagging behind. The countries have access to international funding (funds from the International Monetary Fund and the World Bank) and to the EU pre-accession funds.

However, transition countries must also rely on foreign direct investment to help them in their transformation. Foreign investors bring not only money but also technology and know-how; they start new companies and create jobs. In this area the Western Balkans can learn from the experience of the CEE countries how to attract investors.

There are several reasons for investing in this region. The Western Balkan countries are small, stable, diverse economies that offer lower taxes and a cheaper labour force than EU Member States. They have applied for EU membership, have a prospective EU future and are located in the EU neighbourhood. However, the ratio of FDI to GDP is lower than that of EU Member States.

The main research question of this analysis is: why do the Western Balkan countries not attract foreign direct investors as much as they could?

The research hypothesis is that political instability and corruption in the region discourage investors.

The analysis is organized as follows. After the introductory part, the economic background and history of the Western Balkan countries is presented in Section 2. Section 3 analyses the main investors, trade partners, and import and export sectors of the region. Section 4 analyses the business environment in each country and the obstacles investors can face. The last section concludes the analysis and provides recommendations on what the region should do in order to increase FDI inflow.

The Economic Background of the Western Balkans

Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia, together with Croatia and Slovenia, formed the Socialist Federal Republic of Yugoslavia (SFR Yugoslavia), a country that was known for its unique system of market socialism. Some of the characteristics of the system were the state ownership of the economy, monopoly over the most important spheres of the economy, controlled prices, and limited trade and investment.

Map 1
Socialist Federal Republic of Yugoslavia in 1990

The state ownership of enterprises was accomplished through the nationalization and expropriation of private property. Private property was restricted by law, since private property was not considered compatible with the socialist economic system. Enterprises in the same industry were united within each republic under a central federal directorate. The state was responsible for the allocation of raw materials and fuel, done in accordance with production plans. Therefore, enterprises produced what they were ordered to, and their main objective was to maximize production regardless of costs. In order to fulfil the plans, the enterprises had to sacrifice the quality of their products. Since there was no competition among the enterprises, there was no positive effect on the quality of goods and labour productivity. After World

War II, Yugoslavia pursued rapid industrialization, where priority was given to heavy over light industry. The economies of the former Yugoslav republics are still characterized by the production of less sophisticated goods: over 50% of the manufactured goods in the Western Balkans is classified as labour and resource intensive or low-skill and technology intensive, in comparison to 30% in the European Union.

In addition, the state had a monopoly over the most important spheres of the economy, such as investment, banking, and foreign trade, and administrative control of most prices, which were fixed by specialized institutions.

SFR Yugoslavia ceased to exist in its original form in 1991. Slovenia and Croatia declared their independence on 25 June, 1991, followed by Macedonia on 25 September, 1991, and Bosnia and Herzegovina on 1 March, 1992. On 28 April, 1992, the Federal Republic of Yugoslavia was formed, consisting of Serbia and Montenegro. The country was renamed the State Union of Serbia and Montenegro on 4 February, 2003. Montenegro declared its independence on 3 June, 2006. Kosovo, which was an autonomous province in Serbia, declared its independence on 17 February, 2008.

The beak-up of SFR Yugoslavia was followed by wars – in Slovenia (1991), Croatia (1991-1995), Bosnia and Herzegovina (1992-1995), and Kosovo (1998-1999), which delayed the region's transition to market economy. Slovenia joined the European Union in 2004, while Croatia joined in 2013. The other countries are candidates or potential candidates for EU membership. In the 1990s, the economies faced structural problems: hyperinflation, slow economic growth, high public deficits, and depreciating exchange rates.

The countries of the Western Balkan region have made some progress towards EU membership and have been going through the transition process. Their economies are characterized by high unemployment, a widespread informal economy, low economic openness, and insufficient competitiveness on the world market. However, they also have stable currencies, high growth rates, and relatively low general government debt.

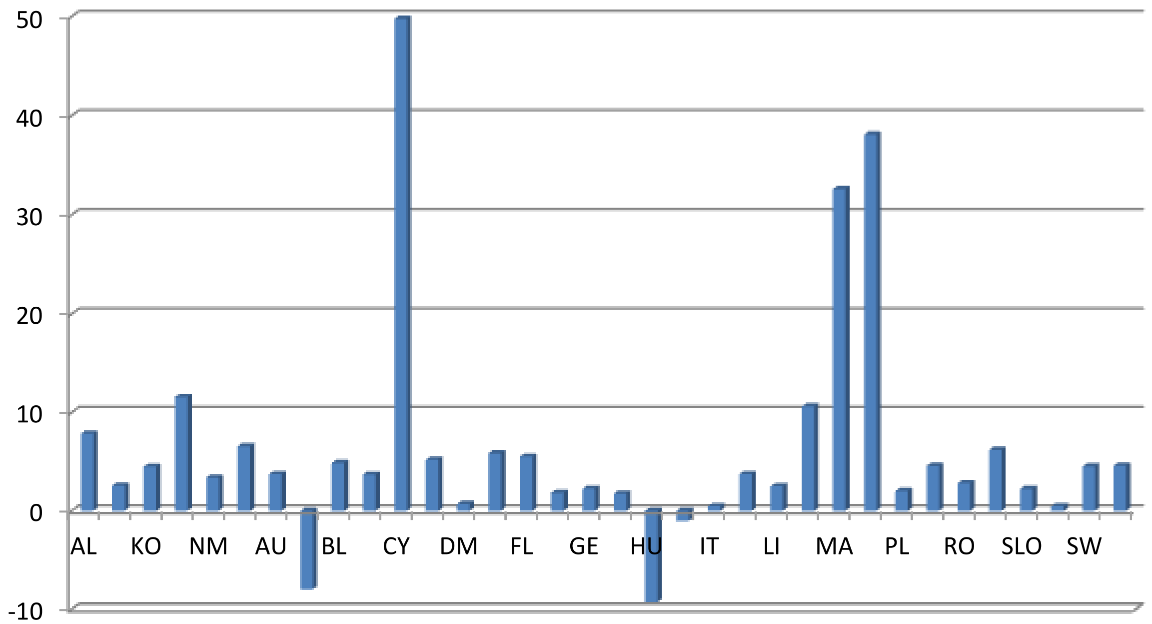
Foreign Direct Investment and Trade in the Western Balkans

The Western Balkan countries must rely on foreign direct investment (FDI) to help them transform from centrally planned to market economies more quickly. FDI brings the new capital that induces economic growth and convergence, improves existing business procedures, updates obsolete technology and brings new technology, opens new markets, increases the potential for trade, and brings management know-how. Transition countries seek new ways to attract investors and increase FDI inflow because the previous system was inadequate.

The countries of Central and Eastern Europe, which have a similar economic history to the Western Balkan region, used FDI during their transition process. It was expected that they would not perform well in the first years after the enlargement and that they would produce labour-intensive products. However, these countries started to produce capital-intensive products, and there was trade creation instead of the expected trade diversion.

In 2017, the average share of FDI in the GDP of the Western Balkan countries was 6.24%, compared to 2.38% in the CEE countries[1] and 6.29% in the EU-28 (see Chart 1).

Chart 1
Foreign Direct Investment (% of GDP)
in the Western Balkans and European Union Countries



Inflows of FDI have helped transform industries and increase exports, but FDI is still low as a share of GDP, and its growth is slow. The Western Balkan region has many strong points, such as macroeconomic stability, the prospect of integration into the EU, a strategic geographical position, favourable taxes, low wages, and diverse economies, which attract foreign investors.

The main investors in the Western Balkan region are EU Member States. Among other countries, Switzerland is a major investor in all the Western Balkan countries; Russia invests in Bosnia and Herzegovina and Montenegro, and Turkey invests in Albania, Kosovo, and North Macedonia. Intra-regional cooperation is less represented. Serbia invests in Bosnia and Herzegovina and Montenegro, and Albania invests in Kosovo (see Table 1).

1 Hungary had a negative value of FDI in 2017, which indicates that the outflows of investment exceeded the inflows

Table 1
Foreign Investors in the Western Balkan Region

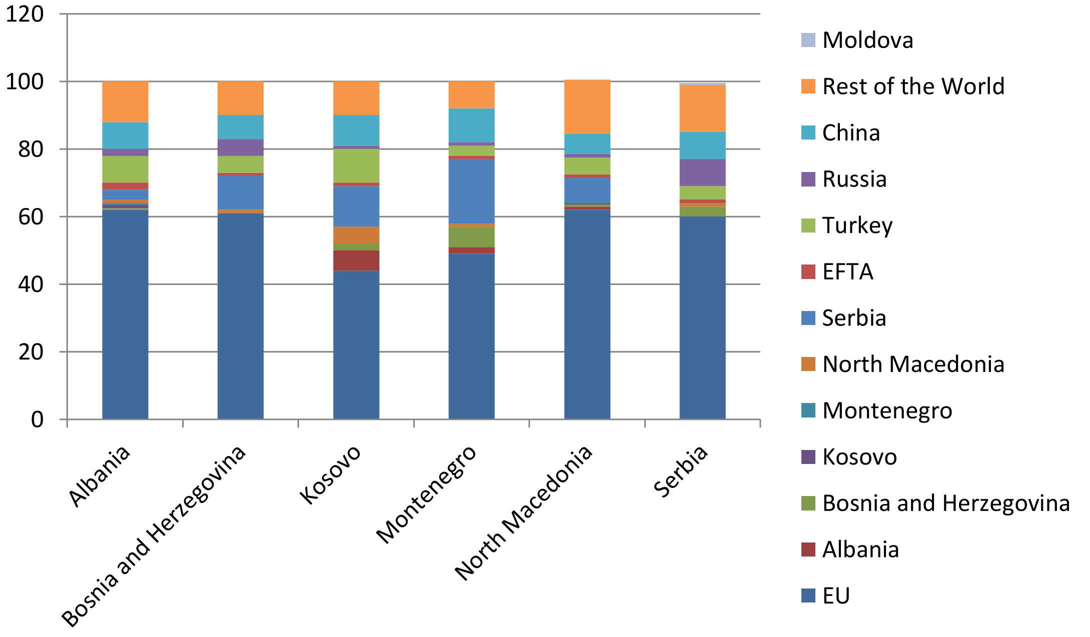
Country	Foreign Investors
Albania	Switzerland, Greece, the Netherlands, Canada, Italy, Turkey, Austria, France, Cyprus
Bosnia and Herzegovina	Austria, Croatia, Serbia, Slovenia, the Netherlands, Russia, Germany, Italy, Switzerland, the United Kingdom
Kosovo	Turkey, Germany, Switzerland, Slovenia, Austria, USA, Albania, the United Kingdom, the Netherlands
Montenegro	Italy, Russia, United Arab Emirates, Cyprus, Serbia, Croatia, Slovenia, the United Kingdom, Switzerland, Austria
North Macedonia	Austria, the United Kingdom, Greece, the Netherlands, Slovenia, Germany, Turkey, Hungary, Switzerland, Cyprus
Serbia	The Netherlands, Austria, Cyprus, Germany, Slovenia, Italy, Switzerland, Russia, Luxembourg, France

One of the most important advantages for the Western Balkan region is its geographical proximity to the EU. The region shares borders with EU members (Croatia, Hungary, Romania, Bulgaria, and Greece), and it has easy and free access to EU markets. In 2000, the EU granted autonomous trade preferences to all Western Balkan countries. These preferences allow nearly all export to enter the EU without custom duties or quotas, with the exception of sugar, wine, baby beef, and certain fishery products. All Western Balkan countries, except Kosovo, have signed a free trade agreement with the European Free Trade Association (EFTA), which is the intergovernmental organization of Iceland, Liechtenstein, Norway, and Switzerland. The Western Balkan countries, together with Moldova, are members of CEFTA, which is a trade agreement among non-EU countries and serves as a transitional organization for the countries that are in the process of joining the European Union. Members of CEFTA are able to trade without having to go through obstacles such as tariffs, taxes, and other barriers.

The Western Balkan countries on average import 56% of all goods from the EU. Even though they are members of CEFTA, intra-regional trade is not pronounced. Albania and North Macedonia import from all the Western Balkan countries, while the others do not even have one country as their main import partner. Intra-regional import of goods ranges from 4% in Serbia to 25% in Kosovo. Other major trade partners are the EFTA countries, as well as Turkey, Russia, and China (see Chart 2).

Chart 2

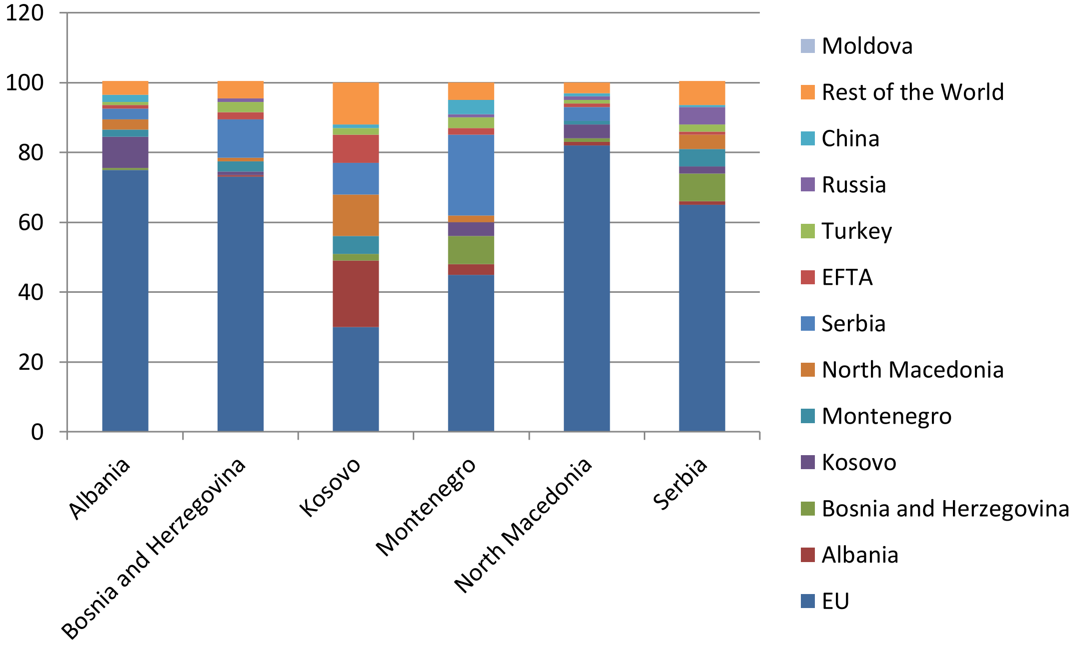
Import of Goods in the Western Balkan Countries



The countries export from 30% (Kosovo) to 82% (North Macedonia) of their goods to the European Union, and from 11% (North Macedonia) to 47% (Kosovo) to other Western Balkan countries. All Western Balkan countries export to other countries in the region (see Chart 3).

Chart 3

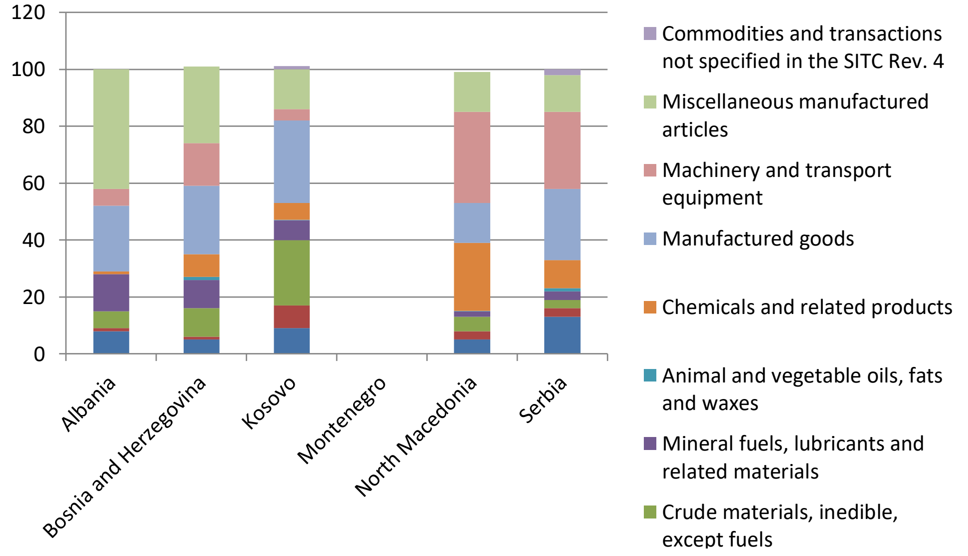
Export of Goods from the Western Balkan Countries



The Western Balkan countries[2] mostly export manufactured goods (23% on average) and miscellaneous manufactured goods (21.4% on average), while less than 1% of export goes to chemicals and related products (see Chart 4).

Chart 4

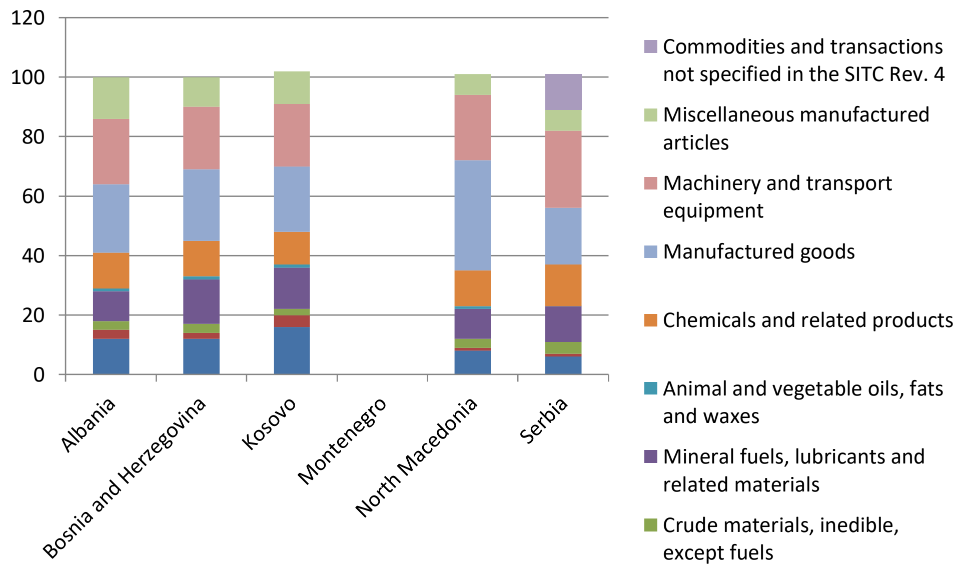
Export by Sector in the Western Balkans



The countries[3] mostly import manufactured goods (25% on average) and machinery and transport equipment (22.4% on average). Chemicals and related products make up less than 1% of the average import in the region (see Chart 5).

Chart 5

Import by Sector in the Western Balkans



2 Data for Montenegro is not available
3 Data for Montenegro is not available

The economies of the Western Balkan countries are quite diverse and do not rely on one sector, which can attract foreign investors (see Chart 6).

Chart 6
Analysis of gross value added by economic activity in 2017

On average, services account for 62.2% of total gross value added (GVA) in the Western Balkan countries, ranging from 54.4% in Albania to 72.2% in Montenegro. The rate is 11.1 percentage points lower than the EU-28 average. The importance of services increased in the five Western Balkan countries in the period 2007-2017. The largest increase was recorded in Albania (3.2 percentage points). North Macedonia is the only country that experienced a decrease of 2.6 percentage points.

Even though industry accounts for 20% of the region's average GVA, the rates vary across the countries. Its role is of particular importance in Serbia (26.5% of GVA), followed by Bosnia and Herzegovina (22.6%), Kosovo (21.8%), and North Macedonia (20.6%), while the lowest rate is in Montenegro (11.2%).

Manufacturing is the predominant industrial subsector in Albania, North Macedonia, and Serbia. These countries mostly produce food, clothing, and furniture. Bosnia and Herzegovina, Kosovo, and Montenegro rely on the production of raw materials. Because securing a sustainable supply of raw materials is a key priority for the EU, and due to the proximity to the EU and the corresponding low transportation costs, some industries can develop faster in these countries (see Table 2).

Table 2
Industrial subsectors in the Western Balkan countries

Country	Industries
Albania	Food; footwear, apparel and clothing; lumber, oil, cement, chemicals, mining, basic metals, hydropower
Bosnia and Herzegovina	Steel, coal, iron ore, lead, zinc, manganese, bauxite, aluminum, motor vehicle assembly, textiles, tobacco products, wooden furniture, ammunition, domestic appliances, oil refining
Kosovo	Mineral mining, construction materials, base metals, leather, machinery, appliances, foodstuffs and beverages, textiles
Montenegro	Steelmaking, aluminum, agricultural processing, consumer goods
North Macedonia	Food processing, beverages, textiles, chemicals, iron, steel, cement, energy, pharmaceuticals, automotive parts
Serbia	Automobiles, base metals, furniture, food processing, machinery, chemicals, sugar, tires, clothes, pharmaceuticals

Compared to the EU-28 average, the Western Balkan countries are quite agriculture-intensive. Agriculture, forestry, and fishing comprised 10.9% of the region's GVA in 2017, ranging from 7.3% in Serbia to 21.7% in Albania. The countries mostly produce wheat, fruits, vegetables, dairy, and livestock (see Table 3).

Table 3

Agricultural Products Produced in the Western Balkan Region

Country	Agricultural Products
Albania	Wheat, corn, potatoes, vegetables, fruits, olives and olive oil, grapes; meat, dairy products; sheep and goats
Bosnia and Herzegovina	Wheat, corn, fruits, vegetables; livestock
Kosovo	Wheat, corn, berries, potatoes, peppers, fruit; dairy, livestock; fish
Montenegro	Tobacco, potatoes, citrus fruits, olives and related products, grapes; sheep, wine
North Macedonia	Grapes, tobacco, vegetables, fruits; milk, eggs
Serbia	Wheat, maize, sunflower, sugar beets, grapes/wine, fruits, vegetables beef, pork, and meat products, milk and dairy products

Construction accounts for 7.1% of the economies on average, ranging from 4.6% in Bosnia and Herzegovina to 10.7% in Albania.

The Business Environment in the Western Balkans

The Western Balkan countries have many advantages when it comes to attracting investors. However, the rate of FDI as a percentage of GDP is still low in the region, ranging from 2.6% in Bosnia and Herzegovina to 7.8% in Albania. This rate should be higher, considering that transition countries rely on FDI to bring in new capital, technology, and managerial style, and to open new businesses and employ people.

According to the World Bank Doing Business report, Bosnia and Herzegovina is the most unfavourable country to invest in. It takes 81 days, thirteen procedures, and EUR 685 to start a new business. The country is ranked 183rd out of 190 economies in the Doing Business topics on starting a business. Kosovo is the most favourable place to start a business in the Western Balkans. It takes only 5.5 days, three procedures, and EUR 20-50 to start a new business, and the country is ranked 13th out of 190 economies (see Table 4).

Table 4
Starting a Business in the Western Balkan

Country	Procedures	Time (days)	Cost (% of income per capita)	Cost (EUR)	Paid-in min. capital (% of income per capita)	Doing Business Rank Score	Ranking on Starting a New Business
Albania	5	5	11.3	497-514	0.0	63	50
Bosnia and Herzegovina	13	81	14.9	685	11.1	89	183
Kosovo	3	5.5	1.0	20-50	0.0	44	13
Montenegro	8	12	1.3	86-96	0.0	50	90
North Macedonia	4	14	0.9	68	0.0	10	47
Serbia	5	5.5	2.2	80-89	0.0	48	40

In the European Union, the number of procedures range from three in Estonia, Finland, Ireland, Slovenia, and Sweden to nine in Germany. It takes from three and a half days in Denmark, Estonia, France, and the Netherlands to 37 days in Poland to start a new company. This process is the cheapest in the United Kingdom, EUR 13.6, and the most expensive in Italy, from EUR 4,297.9.

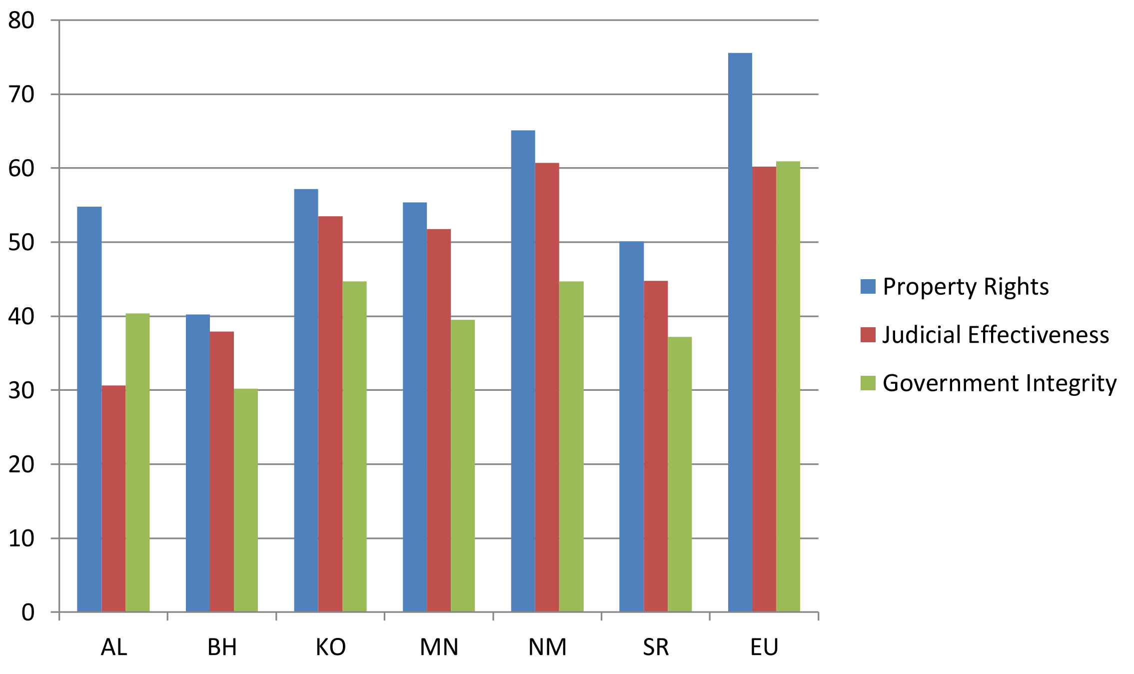
The Western Balkan countries have set up reforms to boost FDI. The countries offer equal treatment to foreign investors and favourable tax rates. Albania has adopted a tax reform that is advantageous to foreign investors and aims at reducing corruption. The Albanian government is working on a law to boost investment. Bosnia and Herzegovina offers low levels of corporate taxation, well-developed industrial zones, and a solid banking sector. Kosovo's rich natural resources, young educated people, a flat 10% corporate tax rate, and temporary exemptions on VAT payments for new exporters have helped attract new investors, even though the country has struggled to attract foreign investors since it declared its independence from Serbia in 2008. Montenegro offers great economic freedom and monetary stability. North Macedonia's legal and regulatory framework is generally favourable to foreign investors and provides numerous incentives to attract them. The country has made significant efforts to harmonize its legal framework with the criteria, standards, and practices of the European Union. Investors benefit from a ten-year tax exemption and free access to public services. Serbia is undergoing economic reforms as part of its EU accession process and has free trade agreements with Russia and Turkey.

Freedom of establishment is guaranteed in all countries. 100% foreign ownership is possible. Bosnia and Herzegovina restricts FDI in some cases because foreign equity ownership of business entities engaged in the production and sale of arms, ammunition, explosives for military use, military equipment, and media shall not exceed 49% of the equity in the given business entity. However, all countries have also faced challenges that discourage foreign investors. Major problems include a lack of transparency, lack of infrastructure, corruption, informal economy, and red tape. The data on the Property Rights index, which assesses the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the state, and measures the degree to which a country's laws protect private property rights and the degree to which its government enforces those laws, show that the average value in the Western Balkans is 53.8, ranging between 40.2 in Bosnia and Herzegovina and 65.1 in North Macedonia. This means that Bosnia and Herzegovina is a corrupt country with a highly inefficient court system with delays so long that it deters the use of the court system. The judiciary is influenced by other branches of government. Expropriation is possible. At the same time, in North Macedonia enforcement of property rights is lax and subject to delays, and the judiciary may be influenced by other branches of government. Expropriation is unlikely. The average value of the Index in the EU is 75.6, ranging from 52.4 in Greece to 92.3 in the United Kingdom (see Chart 7). Private property in the EU Member States is guaranteed by the government, the court system is efficient, with some or no delays, corruption is rare or non-existent, and expropriation is highly unlikely.

Government integrity, which is derived from Transparency International's Corruption Perception Index (CPI), measures how corrupt governments are. Corruption erodes economic freedom by introducing insecurity and uncertainty. The Index values range from 0 to 100: a score of 0 indicates a very corrupt government, while a score of 100 indicates very little corruption. However, tradition and culture have to be taken into consideration. In some countries, small informal payments to service providers or government officials may be regarded as a "tip" for good service, or a corrupt form of extortion in others. The average value of the index in the Western Balkans is 39.5. The most corrupt country in the region is Bosnia and Herzegovina (30.2), while the least corrupt countries are Kosovo and North Macedonia (44.7). The EU countries are less corrupt, with an average index value of 60.9. The average index value in new EU Member states is lower (45.6) compared to old Member States (73). The most corrupt country in the EU is Bulgaria (35.1), and the least corrupt one is Finland (92.5).

Well-functioning legal frameworks protect the rights of all citizens against infringement of the law by others, including by governments and powerful parties. Judicial effectiveness requires efficient and fair judicial systems to ensure that laws are fully respected, with appropriate legal action taken against violations. The score of the Judicial Effectiveness index is derived by averaging the scores of the following factors: judicial independence, quality of the judicial process, and favouritism in the decisions of government officials. Each factor is weighted equally. The average Judicial Effectiveness index in the Western Balkans is 46.6. The lowest index is in Albania, 30.6. In 2016, Albania started a judicial reform which aimed at putting an end to corruption in the system. This reform started with the so called vetting process, which screened all judges and prosecutors in the country. So far, the vetting process has impeached a significant number of judges and prosecutors. North Macedonia has the highest index value, 60.7, which is slightly higher than the EU average (60.2). The country with the least effective judiciary system in the EU is Slovakia (37.2), while the highest score is that of the United Kingdom, 85.9.

Chart 7
Rule of Law Index



Why don't the Western Balkan Countries Attract Foreign Direct Investment?

The Western Balkan countries have many advantages. They are open, diverse economies with a prospective EU membership, close to EU countries; they have macroeconomic stability, low wages, and offer favourable taxes. The Western Balkans should rely on foreign direct investment to bring in new technologies, open new jobs, and help them catch up with the EU more quickly, as EU membership is the ultimate goal for each one of them.

These countries are facing many challenges, especially in the area of political stability. One of the main problems that discourages investors is a high level of corruption. Even though the countries have undertaken some measures in this area and have made some progress, corruption remains a concern.

Another challenge is the political situation in the region. The Western Balkan countries, except for Albania, were part of Yugoslavia. The dissolution of the country in the early 1990s led to wars in Slovenia, Croatia, and Bosnia and Herzegovina in the period 1991-1992, and in Kosovo in 1999. Kosovo declared its independence from Serbia in 2008 and has not been recognized as an independent country by five EU Member States (Cyprus, Greece, Romania, Slovakia, and Spain).

The most unstable country is Bosnia and Herzegovina. This is one of the most corrupt countries in Europe, with one of the most complicated political systems. The country consists of two entities (the Federation of Bosnia and Herzegovina and Republika Srpska) and the Brcko District. The Federation consists of ten cantons, each of which has its own government. If an investor wants to start a business in Bosnia and Herzegovina, it is difficult to explain that the same rules and laws are not applicable in the territory of the entire country. The country's last general election was held in October 2018, and the political parties were not able to form the Council of Ministers for fourteen months. On 5 December 2019, Zoran Tegeltija was appointed as the chairman of the Council of Ministers of Bosnia and Herzegovina. Also, the country has the most complicated and expensive process of starting a business in the region.

Even though the Western Balkan countries are members of CEFTA, political complexity and history has been characteristic of in this area. In November 2018, Kosovo imposed 100% tariffs on goods imported from Bosnia and Herzegovina and Serbia. The tariffs have not been abolished. The reason for this measure was the fact the Bosnia and Herzegovina and Serbia were among the countries that voted against Kosovo's membership in UNESCO and Interpol, and Kosovo's government stated that it had to protect its economy.

The Western Balkan countries should work more closely to open their economies to more trade and investment, as those are drivers of economic growth and could help these countries catch up to the EU. They should learn from the experience of the CEE countries, which were pioneers among the former socialist countries in attracting FDI. FDI will create new jobs, and with high unemployment rates (the average unemployment rate in the Western Balkans in 2017 was 20.4%), people migrate to the countries of the EU. Some projections state that by 2035 the population of the Western Balkans will decrease by 1 million. But people do not leave these countries just because of the economic perspective of the EU; they leave because of uncertainty and the constant threat that wars will occur again. How can the Western Balkan countries attract foreign investors when their people are running away from the region?