

Business Environment and Foreign Direct Investment in Kosovo: an Overview of the Relationship Between Institutional Reforms and FDI

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Abstract

This paper analyses factors outlining the doing business environment, with reference to Kosovo, by focusing on some of the main determinants of attracting Foreign Direct Investments (FDI). It accentuates that in order to create favorable conditions to increase the flux of FDI, transition countries, including Kosovo, need to conduct a wide range of structural reforms, related not only to the reform of portfolios directly related to economy, but also to the improvement of the legal system and functioning of the democratic system in general. The paper used literature review and analysis of set of reforms undertaken from Kosovo institutions in order to attract FDI and improve the business environment. Moreover, the paper elaborates some of the important factors defining the doing business environment. There is a wide consensus in terms of recognizing the role of FDI for transition economies. Kosovo recognizes the significance of FDI and their impact on country economic development. For this purpose, its institutions have undertaken a range of reforms in terms of improving doing business environment. It is accentuated that Kosovo has many preconditions for increasing FDI inflows thanks to its natural resources, human capital, free access to major markets etc. However, apart from progress made in improving the doing business environment, Kosovo faces numerous challenges related not only to structural reforms of resources directly related to economy, but also with improving legal system and better functioning of the democratic system in general.

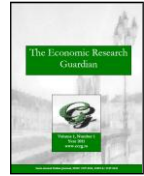
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1. Introduction

Foreign Direct Investment (FDI) constitutes a very influential component of economic growth for developing countries. Numerous studies show that in order to adapt to new market economy circumstances and increase the level of competitiveness of their economies to operate successfully in a context of globalized economy, transition countries had to undertake series of reforms. These reforms are not limited only to changing the economic model, but also include



fundamental institutional transformation. In order to overcome these transformation challenges, transition countries faced a lack of necessary potential and resources to fund projects related to enterprise restructuring, improvement of infrastructure, administration reform and consolidation of democratic institutions. In this context, FDI have taken on a role of meaningful source in economic and institutional transformation of transition countries. Moreover, apart from the positive effect created by FDI as a fresh, outside capital, they also produce multiple positive effects upon host country economies. Knowing that the majority of FDI come from the developed countries, there is a wide consensus among scholars who claim that they are used to transferring technology, information, work and management culture and contemporary knowledge about marketing and sales (see i.e. Cooper, 2001; Bisson, 2012). Moreover, FDI impact positively increased quality of products and services and subsequently, growth of exporting capacities of the country and improvement of trade balance (see, among others, Ghosh and Wang, 2009; Benassy-Quere, Coupet and Mayer, 2007).

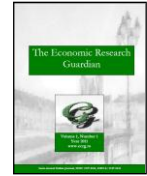
In light of the above, which is further supported by various empirical studies claiming that FDI impact directly economic growth in the developing countries (Ghosh and Wang, 2009), state governments focusing on economic development make numerous efforts to create a business-enabling environment. These efforts must be consistent in order to keep the country continuously competitive with other countries that do the same. Such efforts of governments make them directly competitive with one another in order to be as attractive as possible for absorbing FDI (Rose-Ackerman, 2004).

To achieve this goal, host country is expected to undertake a range of important structural reforms. For that purpose, many countries have incorporated the objective of improving the business environment in their national economic development strategies (World Bank, 2005). Improving the doing business environment implies a multi-dimensional transformation within transition countries, including, as explained below, a wide range of factors to be reformed, impacting the full range of business activities and functionality of country institutions.

The paper is organized as follows: Introduction is given in Section 1. Section 2 provides an explanation of the theoretical framework of business environment and its relation to attracting FDI, by delving on some of the main determinants, section 3 analyses business environment in Kosovo, focusing on efforts of national institutions to improve the business environment. Section 4 presents conclusions and some policy recommendations.

2. Theoretical framework on business enabling environment and incentives for attracting FDI

There are several theoretical classifications related to incentives offered to international companies to invest in different countries. One of them is FDI classification into horizontal and vertical FDI (Markusen, 1995; Dunning, 1993; Markusen and Venables, 1999). Horizontal FDI (market-seeking FDI) include those investments that are primarily aimed at market-seeking purposes in the host country. According to this model, the motive behind which foreign companies decide to invest in another country is to get closer (by opening branches) to their customers in the host country market by positioning themselves better than their local competitors operating within the same market (Markusen, 1995). Small markets with low purchasing power have been traditionally less probable to attract this kind of investments. However, today when small markets like Kosovo are getting integrated into larger free-trade areas



such as Central European Free Trade Agreement (CEFTA) or Stabilization and Association Agreement (SAA) with the EU, such investments are to be expected.

On the other hand, vertical FDI (resource-seeking FDI) include investments of companies in a foreign country because of the resources the host country possesses (for instance minerals, raw materials etc.). Additional incentive for this kind of investment includes other advantages that have an impact on lowering the operational costs of investors in the host country, such as cheap labor force (Dunning, 1993). These kinds of investments are high in the quantitative terms and can greatly influence the export capacity of the host country. However, the host country government has to be cautious enough and, before giving its own resources for use, it should draw good benefits (financial, technological and environmental) that will impact the economic development and citizens' wellbeing.

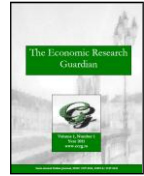
Another type of FDI is efficiency based ones (efficiency-seeking FDI). The incentive to undertake these investments is that it enables companies to rationalize their resources, through distribution on strategic markets - in order to cover the customers in the best manner possible - increasing thereby their efficiency and reducing the costs. In such cases, "Investment companies benefit from differences characterizing different markets in a specific region, including the price difference, different levels of economic development of these countries, differences between customer tastes and preferences and supply capabilities" (Dunning, 1993, 58).

It can be said that there is still no predominant theoretical framework explaining the incentives of foreign direct investment, and therefore different authors use different theories. However, it is important to stress that efforts to analyze FDI have increased in parallel with an enormous growth of foreign direct investments in transition countries in the last couple of decades and are primarily based on empirical researches that measure factors or determinants individually as well as political, economic and socio-cultural specifics of the host countries.

Below we will explain some of the main factors of doing business environment that directly incentivize investors to bring their capital to the host country.

According to World Investment Report, FDI determinants are classified into three main groups, including: political factors, economic factors and business facilitation factors (UNCTAD, 1998). In terms of political factors, the most important is the so-called 'institutional factor', which bears the major burden of addressing most of the aspects related to improving the business environment in a given country.

As it is well known, transition countries have faced numerous problems in the process of their own transformation into a democratic society with free market economy. In this context, some of the main barriers that are seen as inhibiting FDI attraction are: lack of rule of law, political instability followed by political unrest and violence, high level of corruption, inefficiency of administration, lack of transparency and accountability, lack of freedom of expression, violation of human rights etc. (Bisson, 2012; Schneider and Matei, 2010). In such an environment, investors follow closely the institutional quality component or good governance, i.e. how capable are host country institutions to eliminate these barriers. Some detailed studies related to these issues are elaborated in studies of Barrell and Pain (1999), Busse and Hefeker (2007), Fiess et al. (2010). For instance, probability of seeing foreign investors arriving in a country with high level of corruption is very limited, considering that operation of these companies in such environments would increase the risk and operational costs (Xu, 2010). According to Wei (2000), lack of institutional quality, where corruption and extortion are a way in which civil servants



operate, creates the so called ‘climate of distrust’ that keeps the foreign investors away. Besides corruption, long-term political stability and democratic functioning of institutions are also important and impact investors who do not want to operate in countries with unstable political environment (Rose-Ackerman, 2004). Long-term political and institutional stability ensure economic policy coherence as well as legal security that are vital components for investors. Numerous studies show that the lower the level of political risks in the country is the higher FDI flux (Schneider and Matei, 2010). Therefore, it may be said that sustainable and democratic institutions are vital for a country to be seen as a serious destination for foreign direct investments. Extensive analysis on the importance of political institutions, governance and democratic stability including free elections and political risk, can be found in the studies of Anghnel (2005), Busse and Hefeker (2007), Biglaiser and Garland (2009), Wernick et al (2009).

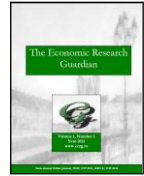
Other inherent factors related to doing business environment that incentivize attracting of FDI or lack thereof, are economic factors. There is a long list of economic factors and their significance differs from country to country or from the point of view of scholars and investors. For instance, Bisson (2012) stresses that lack of infrastructure and skilled human capital prevents the flux of FDI. World Bank (1997) pays greater attention to a stable macroeconomic environment and sufficient capacities to manage economic affairs. Human capital, physical infrastructure (roads, railways, electricity, telecommunication), innovation infrastructure, macroeconomic stability, banking system, market liberalization, market size, cross-border trade, income per capita, economic growth level, structure of host country market, access to regional and global markets, prices of raw materials etc., all these are important economic factors whose specifics and development level are taken into account by investors before taking their decision in which country to invest (Dunning, 2004).

In addition to political and economic factors, host countries' incentive policies - or business facilitation factors - also have a very positive impact on attracting FDI, where state governments in order to attract FDI create numerous facilities for businesses, such as: fiscal policies, different tax relief measures, economic zones, customs exemptions, putting assets into use, grants and different funding schemes etc.

3. Business environment in Kosovo

3.1. Preconditions to attract FDI

Numerous studies underline that each country has its own specifics as regard to opportunities of doing business, including advantages and disadvantages. Unlike many other European transition countries, Kosovo was faced not only with the challenging process of transition but also with repairing multidimensional damages caused to it as a consequence of war. This specificity has had an impact also on the doing business environment, namely on the oftentimes prejudicial way in which foreign investors saw Kosovo as an investment location. In this context, Kosovo had an additional duty to work on eliminating the so called ‘psychological distance’ from foreign investors created during the long history in which the country was depicted as a conflict and political instability arena and not as one offering opportunities for doing business. In order to eliminate this obstacle, the country should work with persistence, among others, in order to



promote to international companies the positive results already achieved as regard to improving its doing business environment.

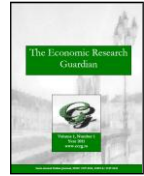
Kosovo has a lot of preconditions and assets in terms of increasing the flux of FDI. In the recent years, Kosovo has managed to create free access to the regional markets through Central European Free Trade Agreement (CEFTA) which includes 7 non-EU countries such as Albania, Bosnia & Herzegovina, Kosovo, North Macedonia, Montenegro, Moldova and Serbia, and as of 2016, access to the European Union market through Stabilization and Association Agreement (SAA). Kosovo is also part of Generalized System of Preferences Program with USA, Japan and Norway, and it has signed a Free Trade Agreement with Turkey. Integration into these markets assists foreign companies, not to see Kosovo as a small market, but as an opportunity, by using its cheap labor force (among other advantages) to conduct their manufacturing operations targeted to large markets. When it comes to economic interaction between Kosovo and these markets, it can be said that despite all the expected obstacles in the initial period – during which national companies need to face challenges of competition against the more powerful and experienced companies from abroad – in the medium and long term, as evidenced in the example of the economies of the Central European countries (for instance Hungary, Czech Republic and Slovakia), effects would be positive both for entrepreneurs and country's economy.

Apart from fulfilling an important component, namely being part of larger markets, Kosovo offers a lot of other preconditions that can serve as an incentive for the arrival of foreign investors in the country, such as for instance, considerable mineral resources, human capital, assets remaining from privatization process and many other sectors.

3.3. Reforms undertaken by Kosovo institutions to improve business environment and attract FDI

As a result of the consolidation of the institutional factor, and by recognizing the importance of FDI for the country's economy, in recent years Kosovo has been working more intensively to improve the doing-business environment and foster economic activity. Progress has been made in improving many determinants that fall under the three main above-mentioned factors (political, economic and business facilitation factors).

Progress has been made in building a legal system in accordance with EU legislation, including also Law on Foreign Investments that ensures equal treatment of foreign and domestic investors. Bilateral agreements have been signed with a number of countries to protect and promote investments and avoid double taxation. These agreements ensure protection and security, free transfer of funds, free repatriation of profit and dividends, protection against retroactive application of laws, protection against expropriation. In the area of fiscal reforms and incentives for investment promotion, some positive results have been noted which have a positive impact on improving the business environment. For instance: as of September 1, 2015, the new fiscal package aimed at promoting the formal economy has entered into force; dividend tax rate is 0%; currently, work is being done on applying tax breaks for businesses, whose duration will be determined depending on the level of investment amount and the number of new jobs they will create. In order to encourage the manufacturing activity, steps have been taken to liberalize import for production lines and equipment necessary for production, for raw materials (that



cannot be found in Kosovo) as well as for information technology equipment. In order to fulfill the component of cheap operational costs, seen as an incentive for investors, Kosovo applies low tax rates.

Regarding the removal of administrative barriers, results have been achieved in shortening the time and reducing the cost of business registration that is now free of charge and can be done within two days. Progress has been made in reducing permits and licenses, contract execution etc. From the perspective of creating the physical infrastructure for work, investments have been made in creating business parks and incubators and economic zones. Solid results are achieved in terms of improving the quality infrastructure, protecting intellectual and industrial property.

3.4. Continuation of Reforms and Development Strategy

Reforms to improve the business environment are complex and require constant and inter-institutional engagement. Like many other developing countries, Kosovo transformed this objective into a priority, by making it a composite part of National Council for Economic Development (NCED) Agenda. In the absence of genuine empirical research measuring quality of doing business factors (advantages and disadvantages), and also investors' preferences for specific industrial sectors, Kosovo primarily takes into account researches of international organizations, especially the World Bank 'Doing Business' report. World Bank report compares ease of doing business in 190 different world countries. It analyses 10 indicators such as: starting a business; dealing with construction permits; getting electricity; registering property; getting credit; protecting minority investors; paying taxes; trading across borders; enforcing contracts; resolving insolvency, hence assessing several components that characterize the ease of doing business. Information is collected from the field through surveys, by providing thereby a solid empirical basis that serves to develop the final index. Report indicators address important aspects of doing business in a given country, such as: legislation and its implementation, infrastructure, efficiency of administrative services (bureaucracy) and financial market. World Bank Report is considered one of the most credible reports that analyses several important indicators and therefore its results and recommendations are taken into account either by state governments, or by companies interested to invest in different countries. The latest World Bank 2019 report ranks Kosovo as 44th.

Compared to several years ago, it can be said that considerable progress has been made. However a lot remains to be done to improve some indicators where Kosovo was ranked lower. Within reforms to improve doing business environment in the country, Kosovo Government takes into account recommendations from the World Bank report, and it harmonizes them with other national strategies, such as: National Development Strategy, Economic Reform Program, SAA process etc. Ministry of Trade and Industry - as a coordinator of the National Council for Economic Development - is responsible to coordinate work related to this process. Its role is to prepare recommendations and identify responsible institutions (on central and local level) that address all issues related to implementation of these reforms.

It should be stressed that in parallel with direct efforts to implement reforms, expertise-based sectoral development policies are important, as they assist the state government to define and establish its strategic industrial sectors. In relation to this Lyubov (2009) states that countries that



direct FDI towards specific sectors or industries create preconditions that foster the arrival of investors. In this spirit, Kosovo Government is working on establishing strategic sectors within its National Development Strategy. While on the other hand, through adapted Law on Strategic Investments it aims at offering considerable facilities that are expected to encourage major international companies to spread their investment activities in Kosovo. Reform process should be continuous and paired with genuine analyses, measuring effects of previous policies in every sector. In this regard, it is worth mentioning that assets remaining from privatization process, a component featured throughout the literature as an incentive to attract FDI, may influence the increase of Kosovo's offer towards foreign investors classified as 'asset seekers' (asset-seeking FDI).

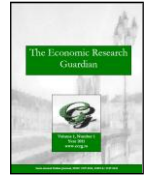
4. Conclusion

This paper elaborated some of the important factors defining the doing business environment. As mentioned already, there is a wide consensus in terms of recognizing the role of FDI for transition economies, not only financially, but also in terms of other value-added inputs they bring to host country economies. Kosovo recognizes the significance of FDI and their impact on the economic development of the country. To this end, its institutions have undertaken a range of reforms in terms of improving doing business environment, in order to attract as many foreign direct investments. Also, as in many other countries, Kosovo positioned improvement of doing business environment on its national agenda by treating this process within the National Council for Economic Development, that delegates duties related to reform implementation to responsible institutions at the central and local level, in cooperation with representatives of businesses and international partner organizations. It was also accentuated that Kosovo has many preconditions for increasing FDI inflows, thanks to its natural resources, human capital, free access to major markets etc.

Apart from progress made in improving the doing business environment, Kosovo faces numerous challenges related not only to structural reforms of resources directly related to economy, but also to improving the legal framework and better functioning of the democratic system in general. In that regard, in order to achieve better results in attracting FDI the country needs to focus decisively on achieving a range of important objectives, such as: building of long-term political stability, rule of law, further democratization of institutions, development of coherent economic and expertise-based policies, respect of human rights, transparent and accountable governance, strengthening of intellectual and industrial property, further policies to encourage businesses and investors, quality education in line with labor market needs, development strategies for industrial sectors, revising the model for the privatization of available assets, improvement of physical infrastructure as well as quality and innovation infrastructure.

Another important aspect, seen by scholars as a motivating factor for attracting FDI, is the EU integration process (Dunning, 2004), considering that approximation towards EU implies meeting a set of political and economic standards that make the country's business environment more favorable, thereby fulfilling a range of determinants that influence the growth of foreign direct investment.

It may be concluded that Kosovo has made series of advances in the last years, in terms of improving the doing business environment. However, considering that this process includes a



plethora of factors that characterize the country's general development level, whether politically or economically, still remain a lot of challenges to be addressed for Kosovo to become a destination that will attract higher flux of foreign direct investments.

In this regard, given the link between business environment improvement and FDI growth, a set of policy recommendations are important, and that include (i) Kosovo Government should keep the business environment improvement process high on the agenda; (ii) the institutional structure that deals with the coordination of reforms for ease of doing business should be a permanent mechanism with greater capacity than the current National Council for Economic Development; (iii) the process of improving the business environment to be coordinated with the European integration process through the National Plan for the Implementation of the Stabilization and Association Agreement with the EU.

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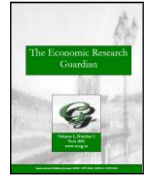
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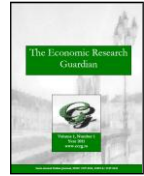
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