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ROLE OF ECONOMIC AND POLITICAL FREEDOM IN COUNTRY'S ATTRACTIVENESS OF FOREIGN DIRECT INVESTMENT (FDI): EVIDENCE FROM THE SOUTH EAST EUROPE

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Abstract: *The aim of this research is to empirically explore impact of economic and political freedom as two nontraditional factors on FDI inflows in eight of South East Europe countries between 2002 and 2020. Accordingly, the study hypothesis that high level of economic and political freedom is positively associated with FDI. The study uses panel data techniques. The obtained findings of the study failed to confirm contribution of economic freedom on FDI in eight South East European countries. It can be explained that a given level of reforms conducted in the field of business freedom, trade freedom, monetary freedom, investment freedom, government size, property rights, freedom from corruption, labour freedom, financial freedom, and fiscal freedom are still lagging from developed countries. On the contrary, the findings confirmed the impact of political freedom on FDI attractiveness and that given level of political freedom contributes to growth of FDI.*

Key words: *economic and political freedom, FDI, panel data techniques, South East Europe*

JEL classification: F21, F23

1. INTRODUCTION

The global trends of FDI recently show that there are variations in percentage share of FDI flows between developed and developing countries. As FDI started to increase in its importance the developed countries were major investors and receivers, but over the years situation was changing and developing countries sometimes created highest percentage share of FDI flows. In this context historically, a country needs to create friendly business and macroeconomic environment including economic and political freedom. All this is really crucial for attracting investments to certain area. Although investment recipient and investment provider can sourced benefits from FDI, the countries make their investment regimes and business practices more friendly. The systems with economic and political freedom seem to work better in terms of FDI inflows.

The number of countries that accommodated to receive and provide FDI almost doubled until the 2000. Thus, in this period global FDI flows were increasing, and the percentage of FDI in and out of the developing countries started to increase comparing to developed countries. The South East

Europe region as many other transition regions need access to foreign capital and modified business environment to make them friendly for foreign investors. It also important in an era of globalization that opens new business opportunities for multinational companies and follow some cross-bordering operations in host economies (Mahmutović et al., 2017).

The aim of this research is to empirically explore impact of economic and political freedom as two nontraditional factors on FDI inflows in selected South East Europe countries. Namely, this study extends the empirical evidence between nonstructural variables and FDI that are less explored than impact of structural variables on FDI.

At the same time, practices in South East Europe are really interesting for observation, because all countries are making both political and economic transition from socialism to democracy and market oriented economy.

Transition started back in 1990s after dissolution of former Yugoslavia. The process of economic reforms launched with the process of privatization of state-owned enterprises, price liberalization, and market deregulation was aimed to improve economic recovery hampered by the Balkan wars between 1990 and 1995. During the reforms in 1990s, public deficits and hyperinflation are some of the problems of economic stagnations faced by the region with considerable catching up needed in foreign capital to finance a relatively high current account deficit (Ganić, 2021).

The study proceeds to answer does Economic and political freedom affect country's attractiveness of FDI flows in eight South East European countries. Accordingly, the study hypothesis that high level of economic and political freedom is positively associated with FDI.

2. LITERATURE REVIEW

Although, selection of investment location is mostly driven by economic indicators there are more cases where presence of non economic elements play import role. Accordingly, an intention here is to examine whether promoting non economic elements as economic and political freedom can impact on attractiveness of FDI.

The economic freedom is very important determinant, and it can enhance FDI inflows to the host country. Some authors as Meyer and Sinani (2009) and Bruno and Campos (2013) point importance of human capital, financial market development in determination of FDI in host economies. In addition, business environment, and institutional regime with EBRD indicators as Index of Economic Freedom, which analyze labor, property rights, fiscal, monetary, financial components and similar can be used in examination of FDI inflows. The study done by Botrić (2010) found high correlation between this indicator and FDI.

A number of recent studies (Obwona, 2001; Bengoa and Robles, 2003; Kapuria, 2007; Pourshahabi et al. 2011; Pearson et al. 2012) found a positive link between FDI and economic freedom. Although there is widespread believe that economic and political freedom support FDI inflows in some empirical studies empirical evidences are inconclusive, or elusive. For instance, some studies as Sayari et al. (2018) and de Haan and Sturm (2000) examined a link between economic freedom and FDI in Eastern, Central and Western European countries and found their marginally significant and negative relationship. One other study done by Ciftci and Durusu-Ciftci (2021) found a weak evidence in terms of causality between economic freedom, FDI and economic growth for some of components of economic freedom.

Voice and accountability defined by Kaufmann et al. 2007 can have positive relations with FDI providing risk free environment for investors. For example, Sabir, et al. (2019) investigated a link between institutional quality and FDI employed a set of low, lower middle, upper of middle countries between 1996 and 2016. Their study finds that most of institutional indicators (control of corruption, rule of law, political stability, voice and accountability, government effectiveness) on FDI inflows are more important and higher level in developed countries than in developing countries.

Some studies done by Bauchanan et al. (2012) and Mengistu and Adhikary (2011) conclude that poor institutions, rise of corruption and nepotism increase cost of doing business and impede FDI inflows. Similarly, Wheeler and Mody (1992), Hines (1995), Cuervo-Cazuro (2008), Azam and Ahmad (2013) found that there is negative correlation between FDI and corruption.

Solomon (2011) used GMM estimator to examine a link between political and economic environment in a panel of 111 countries between 1985 and 2005 and found their strong relationship where market size, political stability and inflation positively influence on FDI inflows. Similarly, Harms and Ursprung (2001) found positive relationship between political rights and FDI inflows.

There are some evidences that politicians and interest groups follow their immoral practices and abuse poor institutional quality for private gains. Penev and Rojec (2014) stress the need to keep a quality of the business and investment environment as an important determinant of inward FDI.

Further, some early conducted empirical studies confirmed a positive relationship between economic integration and FDI inflows (Dunning, 1993; Rosati, 1998). In addition, for countries which are still in process of EU accession there is believe that legal and institutional reforms that can enhance further economic development. It follows that shaping the economic system, governance capacities and establishing good environment for business is highly important for creating good governance indicators and dynamics that will potentially enhance more investments.

Estrin and Uvalic (2010) explained relationship between FDI inflow and institutional determinants, privatization and membership in EU by using of gravity model between Western Balkan countries and EU countries. They discovered that weakness of institutions, the slow pace of privatization and non-membership of the EU affect low FDI flows in those countries.

The most of foreign investments in South East Europe are coming from the EU, mostly because of the proximity of the region, and because of accession negotiations between EU members and the candidate countries (Ganić, 2013). Although Ganić and Hrnjić (2019) could not find statistically significant link between a country's business regulatory environment and FDI in Central Eastern European and Southeast European countries their findings reveal that political stability, European integration process, and reduction costs of business regulations can increase FDI inflows.

The low-income countries usually have low development of business environment, which deters inflow of FDI. For instance, Saidi, et al. (2013) found that good institutional quality encouraging more foreign investments. It implies that country's attractiveness is influenced by a system of good governance. Also, some authors see a close link between lack of transparency and corruption caused by the absence of a system of good governance (Wang and Swain, 1997; Saidi, et al.; 2013). Although, Kayani and Ganić (2021) found control of corruption, rule of law and regulatory quality as significant variable in determination of FDI flows in Chine they could not find significant relationship between political stability, voice and accountability and government effectiveness with FDI flows. Moreover, Mishra and Daly (2007), Samimi and Ariani (2010) finding out that good legal and judicial system have positive impacts on FDI inflows.

3. METHODOLOGY AND DATA

The parameters of FDI function are estimated through panel estimation: Pooled Least square, Fixed effect (FE) model and Random effect (RE) model. By employing Pooled Least square, FE and RE model, some of cross section and period specific effects can be solved.

Pooled Least square or common effect model in our model can be expressed as follows:

$$FDI_{it} = \alpha + \beta' X_{it} + \varepsilon_{it}$$

$i = 1,2\ldots.N$ (Number of cross section)

and $t = 1,2,\ldots..T$ (number of time periods) (1)

Where FDI_{it} is the FDI as percentage of the gross domestic product of country i in year t, X_{it} represent one independent variable (IV) for country i in year t; ε_{it} is the error term.

In the second case, the FE model investigates the relationship between predictor (FDI) and outcome variables (EFRE, POLR, INF, TRO) within a country. Each country has its own individual characteristics (α_i). It can be expressed as follows:

$$FDI_{it} = \alpha_i + \beta' X_{it} + \varepsilon_{it} \quad (2)$$

On the other hand, variations across countries are assumed to be random and uncorrelated with the predictor or independent variables included in model to eliminate heteroscedasticity (Green 2008). The RE model can be expressed as follows:

$$FDI_{it} = \alpha + \beta' X_{it} + u_i + \varepsilon_{it} \quad (3)$$

Where ε_{it} is within country error and u_i is between country error.

Then, the model proposed for our research can be expressed as follows:

$$FDI_{it} = \alpha + \beta_1 POLR_{it} + \beta_2 EFRE_{it} + \beta_3 TRO_{it} + \beta_4 INFL_{it} + \varepsilon_{it} \quad (4)$$

Where i is the country subscript where we have 8 countries: Albania, Bulgaria, Romania, Croatia, Bosnia and Herzegovina, North Macedonia, Montenegro, and Serbia, t is the time subscript between 2002 and 2020, β_0 is the constant, μ is an error term, β_i are the coefficients associated with different variable, FDI (FDI net inflows (GDP %) is dependent variable, EFRE (Economic Freedom Index) is proxy for economic freedom, POLR is voice and accountability as a proxy for political freedom, TRO is trade openness and INFL is the inflation rate as independent variables.

The study hypothesis that a higher economic and political freedom may increase FDI net inflows. To examine which model is preferred and make selection among them the study uses three tests:

Chow test, Hausman test and Lagrange multiplier test.

To test which model is preferred between Pooled LS and Fixed effect a Chow test will be used, whereas Hausman test will decide to follow Fixed effect or Random effect. Also, Test Lagrange Multiplier Lagrange multiplier will be employed to decide whether Random effect is preferred than Pooled LS.

To analyze the determinants of economic freedom and political stability in FDI inflows, two control variables: trade openness regime and inflation rate are included for the eight South East Europe countries: Albania, Bulgaria, Romania, Croatia, Bosnia and Herzegovina, North Macedonia, Montenegro, and Serbia between 2002 and 2020 and sourced from IMF, World Bank or OECD.

A dependent variable of FDI net inflows as percentage of GDP is employed to measure effect of changes in the level of economic freedom and political stability on variations of FDI inflows, while inflation rate and Trade openness regime are used as control variables. FDI net inflows as a percentage of GDP are sourced from the World bank database.

The index of economic freedom prepared by the Heritage Foundation is used a proxy for economic freedom and cover ten variables included in this index (business freedom, labour freedom, trade freedom, monetary freedom, property rights, freedom from corruption, investment freedom, government size, financial freedom, and fiscal freedom). Each of these factors is graded from 1 to 5, where score of 1 implies the best environment with economic freedom and a score of 5 means the lowest. The variable economic freedom is included in our model because some recent empirical studies confirmed positive relationship between economic freedom and FDI inflows or increase of Economic freedom lead to increase of FDI inflows (Obwona, 2001; Bengoa and Robles, 2003; Kapuria, 2007; Pourshahabi et al. 2011; Pearson et al. 2012).

Next variable of voice and accountability is used a proxy variable for measuring political freedom. Generally, it measures a capacity of country's citizens to participate in election of their government, including freedom of expression, freedom of association, and a free media (Kaufmann, et al. 2007). Sabir, et al. (2019) and Saadatmand and Choquette (2012) found positive voice and accountability and FDI nexus.

The openness of trade regime measured trade as percentage of GDP is somehow logical variable in this case, because we know when some company invests in foreign country, it provides more benefits to host country (Brecher and Findlay, (1983); Sabir, Rafique, and Abbas, 2019; Hraiba et al, 2019). The main premise of the studies conducted is that those FDI can be influenced and determined by higher level of trade openness because trade regime is also connected with government readiness and openness to transparently cooperate with another trade partners.

Next control variable, Inflation rates, measured by consumer prices annual %, is included to present macroeconomic (in)stability. High level of inflation discourages investors and leads to decrease FDI inflows in host countries. It is a reason why inflation rate stability is important for country's attractiveness of FDI (Wint and Williams, 2002). One recent study done by Mason and Vracheva (2017) and Hraiba et al, (2019) also confirmed significant relationship between inflation and FDI.

4. EMPIRICAL RESULTS

Table 1 provides correlation matrix of independent variables. As it is shown in Table 1 there is no serious problem with multicolineraty because all explanatory variables have values bellow 0.5. In Correlation matrix values go from -.073 to 0.467 where is no critical correlation between independent variables. For example, a variable of economic freedom is positively associated with voice and accountability and trade openness while negatively correlated with inflation. A variable of inflation is positively associated with voice and accountability while trade openness is negatively correlated with voice and accountability and inflation.

Table 1. Correlation matrix of independent variables

	EFRE	VA	INF	TRO
EFRE	1.0000			
VA	0.1647	1.0000		
INF	-0.2970	0.2369	1.0000	
TRO	0.4678	-0.0730	-0.2957	1.0000

***Source**: Author's calculation*

Additionally, VIF test is used to check multicolineraty because in some cases data where no pair of variables has a high correlation, a group of variables together may be highly interdependent. The value and tolerance of VIF coefficient for each individual variable and as a group is low and it can be concluded that a problem of multicolinearity in our case does not exist.

Table 2. VIF estimates

Variable	VIF	1/VIF
EFRE	1.44	0.694439
TRO	1.35	0.742691
RINF	1.23	0.811071
VA	1.15	0.86976
Mean VIF	1.29	

Source: *Author's calculation*

As shown in Table 3, the output of Chow test implies that FE model is more appropriate than Pooled LS because a value of probability Cross-section Chi-square is less than 0.05% and the null hypothesis is rejected. In the second case Hausman test statistics says that p value is 0.2667. The null hypothesis cannot be rejected for level of significance of 0.05% since that 0.2667 is higher than 0.05%. It reveals that RE model is more appropriate than FE model. And lastly, the output statistics of Lagrange multiplier test implies that RE model is more appropriate than Pooled LS.

Table 3. Specification of model

Pooled LS vs. FE model	Chow test	Cross-section Chi-square stat. 76.083735	Prob>F= 0.0000
Pooled LS vs. RE model	Breusch and Pagan Lagrangian multiplier test	chibar2(01) = 97.39	Prob>chibar2 =0.0000
Random vs. Fixed model	Hausman Test (Correlated random effects)	chi2(5) 5.207257	Prob>chibar2 =0.2667

Source: *Author's calculation*

As shown in Table 4, a variable EFRE as proxy for economic freedom is not shown as statistically significant in determination of FDI inflows.

The variable EFRE has a negative sign and it is not in according with our and theoretical expectations including and Pooled OLS. It can be explained that the current level of economic freedom in sampled countries is a weak and do not impact much on FDI attractiveness. It is not in the line with some earlier empirical.studies done by Obwona, 2001; Bengoa and Robles, 2003; Kapuria, 2007; Pourshahabi et al. 2011; Pearson et al. 2012)

The second variable of VA as proxy for political freedom is shown as highly significant variable in determination of FDI attractiveness in the South East Europe countries in all three models. In RE model as we follow as more appropriate, the output of RE model implies that increase FDI inflows is significantly determined by rise of political freedom. Therefore, the current level of political freedom in the sampled countries can contribute to growth of FDI inflows. It is in the line with studies done by Sabir, et al. (2019) and Saadatmand and Choquette (2012). Rather, it can be explained with some findings obtained Sayari et al. (2018) and de Haan and Sturm (2000).

Further, holding other factors constant a one percent increase in trade openness increases FDI inflows by 7.3%. It indicates that higher trade openness plays important role in attracting FDI inflows among eight South East European countries. It is confirmed some earlier studies as Brecher and Findlay, (1983); Sabir, Rafique, and Abbas, (2019); Hraiba et al, (2019). Also, next control variable inflation confirmed our expectations in determination of FDI and shown as statistically significant.

Table 4. Regression estimates

Variable	Pooled OLS	FE	RE
EFRE	-0.2420138 [-2.93]***	-0.0207615 [-0.23]	-0.061769 [-0.69]
VA	1.838808 [1.97]***	15.1784 [5.26]***	13.10538 [4.86]***
INF	0.1052609 [2.13]**	0.324881 [3.43] ***	0.303462 [3.24] ***
TRO	0.1296168 [5.02]***	0.0633108 [2.04]**	0.073274 [2.42]**
Const	7.832077 [1.70]*	-2.42577 [-0.49]	-0.317491 [-0.06]
Number obs.	152	152	152
F-stat	8.017232 Prob > F = 0.0000	12.99 Prob > F = 0.0000	10.51 Prob > F = 0.0000
R-squared	0.18	0.50	0.22
Adjusted R-squared	0.16	0.46	0.20
DW test	0.672348	1.131486	1.131486

Source: Source: Author's calculation

CONCLUSION

The study serves generally to understand how much government in the South East Europe through their political and economic freedom, do to establish much better and more attractive environment for foreign. Specifically, in this study we explored the impact economic and political freedom as two non-traditional factors on attractiveness of FDI in eight South East European countries.

Even though the study explored another researches and theories and tried to see what evidences from other regions are, results are different if we compare it with South East Europe. One of the reasons is that analyzed countries are passing through economic transition as well as political one.

The obtained findings of our study failed to confirm contribution of economic freedom on FDI in eight South East European countries. It can be explained that a given level of reforms conducted in the field of business freedom, trade freedom, monetary freedom, investment freedom, government size, property rights, freedom from corruption, labour freedom, financial freedom, and fiscal freedom are still lagging from developed countries. Another phenomena is small markets, especially after Yugoslavia ceased to exist, region need to integrate in true sense, lower barriers among themselves in order to improve their position for FDI

These areas are on the list of priority to be improved and upgraded for the governments in the region. It implies that South East Europe countries should put more efforts to create good investment climate for FDI inflows. Also, the findings confirmed the impact of political freedom on FDI attractiveness and that given level of political freedom contributes to growth of FDI.

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SUMMARY

The aim of this research is to empirically investigate the influence of economic and political freedom as two non-traditional factors on the inflow of FDI in selected countries of Southeast Europe. Namely, this study extends the empirical evidence between non-structural variables and FDI that is less researched than the impact of structural variables on FDI. The study goes on to answer whether economic and political freedoms influence the attractiveness of foreign direct investment flows in eight countries of Southeast Europe. Accordingly, the study hypothesizes that a high level of economic and political freedom is positively associated with foreign direct investment. The number of countries that adapted to receiving and providing FDI almost doubled by the year 2000. So, in this period, global FDI flows were on the rise, and the percentage of FDI to and from developing countries began to rise compared to developed countries. The region of Southeast Europe, like many other transition regions, needs access to foreign capital and a modified business environment to make it pleasant for foreign investors. The study hypothesis that a higher economic and political freedom may increase FDI net inflows. To examine which model is preferred and make selection among them the study uses three tests: Chow test, Hausman test and Lagrange multiplier test. To test which model is preferred between Pooled LS and Fixed effect a Chow test will be used, whereas Hausman test will decide to follow Fixed effect or Random effect. Also, Test Lagrange Multiplier Lagrange multiplier will be employed to decide whether Random effect is preferred than Pooled LS. To analyze the determinants of economic freedom and political stability in FDI inflows, two control variables: trade openness regime and inflation rate are included for the eight South East Europe countries: Albania, Bulgaria, Romania, Croatia, Bosnia and Herzegovina, North Macedonia, Montenegro, and Serbia between 2002 and 2020 and sourced from IMF, World Bank or OECD.