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# FOREIGN DIRECT INVESTMENT AND/OR INSTITUTIONS IN THE GROWTH FUNCTION OF THE WESTERN BALKANS: EXPECT THE (UN)EXPECTED

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The economic literature is rich in papers analyzing the effects of FDI inflows or the impact of institutional quality on economic activity. The same is not true for analyzing the impact of institutional quality on FDI attraction and/or the joint impact of these two factors on economic growth, especially concerning the Western Balkans region. Our analysis covers five countries in this region over the period from 2007 to 2022 and aims to contribute to the relevant literature in that segment. The panel data were modelled using the GLS method. The result of the final model (out of the three evaluated) indicates an (un)expected positive effect of a lower institutional quality on economic activity through the FDI channel. One possible explanation for this finding is the hypothesis that “weaker” legislation (especially in the environmental field) in the Western Balkan countries attracts precisely the FDI that generates negative externalities in addition to economic growth. Nevertheless, it also suggests the necessity for considering the long-term risks associated with economic growth, relying predominantly on this type of FDI.

**Keywords:** foreign direct investment, institutions, economic growth, the Western Balkans

JEL Classification: E02, F21, O43, C33

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## INTRODUCTION

The integration of the Western Balkan countries into global capital flows and the development of market conditions in Albania, Bosnia and Herzegovina, North Macedonia, Serbia, and Montenegro have led to an increased inflow of foreign direct investment into this region. In theory, investor interest is based

on high returns, and confidence in the security of investments is strengthened by the continuous improvement in the business climate and economic progress of the economies in which they invest (Hanson, 2001). Additionally, economic theory cites numerous advantages for host countries as well in relation to foreign direct investment (Blomström & Kokko, 1998; Forte & Moura, 2013). Empirical research directions in economic growth, institutions and FDI are mostly based on pairwise analysis, rarely considering the interaction of these variables. Moreover, most analyses have been conducted on the

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example of the EU countries, while studies focusing on the Western Balkan countries are rare (mainly due to problems with data availability and quality). The motivation for this paper stems from an aspiration to provide a valuable input and fill the aforementioned gap in the relevant literature by identifying the mechanisms at work in the interaction of foreign direct investment, institutions, and economic growth for the Western Balkan countries. This paper seeks to provide an insight into the correspondence or divergence of reality from economic theory in relation to the benefits of FDI inflows and the quality of institutions for the Western Balkan countries through the economic interpretation of the results obtained using the quantitative methods applicable to databases with numerous limitations, such as those that exist in the statistics of the region.

The choice of a suitable methodology for the research is determined, among other things, by the characteristics of the region itself. Generally speaking, the Western Balkans experienced significant and growing FDI inflows in the period from 2007 to 2022 (World Bank, 2024a). In terms of total FDI inflows (especially in the last ten years), Serbia dominates (with a share of around 60%), while the average shares for the countries of the region in the mentioned period range from 3.2% of GDP (the FDI share in Bosnia and Herzegovina), to 14.9% of GDP (the FDI share in Montenegro). The structure of FDI varies from country to country, depending on the country of origin and the sector in which the investment is made. A significant share of the manufacturing industry has been recorded in Bosnia and Herzegovina, North Macedonia, and Serbia over the last five years (Eurostat, 2024). Individually, the largest investors in the past few years (2021-2023) for Albania, Bosnia and Herzegovina, North Macedonia, and Serbia have been the Netherlands, the United Kingdom, Turkey and China, respectively, whereas the European Union in its entirety remains the most important investor for the region as a whole (Eurostat, 2024). The quality of institutions varies as well. The indicators measured by the World Bank are quite volatile, with periods of improvement alternating with periods of deterioration. On the other hand, measured in terms of real GDP growth in the same period, economic

growth shows less variation, ranging from 2.4% to 3.3% (World Bank, 2024b). Based upon the above (albeit sparse) data, this region clearly demonstrates a certain degree of heterogeneity, as well as a considerable number of common factors (historical, geographical and economic), which are still the subject of interest (Jano, 2022) and therefore lends itself to some form of panel data analysis. The panel structure reduces to some extent the shortcomings of the individual databases for each country (which is discussed in more detail below), simultaneously allowing for more complex analyses thanks to a larger number of observations.

The following hypotheses are tested in this paper:

- H1: FDI inflows are statistically significant in explaining GDP growth in the Western Balkan countries.
- H2: Institutional quality further enhances the effect of FDI inflows on GDP growth.
- H3: The interaction variable between FDI inflows and institutional quality has a positive effect on the GDP growth rate in the Western Balkans.

After the introductory remarks, the paper is structured as follows: the Introduction is followed by a review of the relevant literature, an overview of the indicators used and the available data, an evaluation of the panel model in three iterations (without the effect of the quality of institutions, with the isolated effect of institutions, with the interaction between the FDI inflow and the indicators of institutions), and the concluding remarks.

## LITERATURE REVIEW

In recent years, a number of papers have dealt with the impact of FDI on economic activity in general, such as those regarding the growth driven by FDI (e.g. Kisswani, Kein & Shetty, 2015; Lee & Dolfriandra, 2020), i.e. the dependence on this type of investment, which is very widespread in the Western Balkan countries. In addition, there are also papers in the

recent literature that focus on analyzing the impact of FDI on some aspects of economic activity, such as the impact this type of investment has on domestic investment (Sucubasi, Trenovski, Imeri & Merdzan, 2021). On the other hand, although the number of the papers dealing with the impact of institutions on FDI flows using the Western Balkan region as an example is not large, their observations and findings also represent an undisputed contribution to the relevant literature and are an important starting point for this research. For example, T. Stevanović, I. Marković and V. Lepojević (2022) use the panel model approach to identify the importance of institutions in attracting foreign capital in the Western Balkans. The main conclusion they come to is that, for the Western Balkan countries observed, the economic benefits of foreign direct investment are real but cannot be achieved automatically and rather depend on the quality of the business environment.

One of the papers indirectly using the indicator of institutions refers to a study of the impact of the composite innovation index on the competitiveness of the economies of the Western Balkan countries. I. Stojanović, A. Puška and M. Selaković (2022) analyzed the impact of innovation in the Western Balkan countries using the GII (Global Innovation Index) in the period from 2019 to 2021. The GII quantifies a comprehensive innovation effect of countries and consists of the indicators for institutions, human capital, infrastructure, market and business development. The authors ranked the Western Balkan countries according to the value of the aforementioned index, with the best result achieved by Montenegro, which has the best overall average value of the indicators for institutions in the period from 2007 to 2022 as well, according to the World Bank's World Governance Indicators database.

R. Desbordes and V. Vicard (2009) also raise the question of the causality between the quality of institutions and the inflow of foreign direct investment. One of the conclusions they come to is that return on FDI depends to a considerable extent on the quality of political relations between the country of origin and the country in which the investment is made. Similarly, A. Dorakh (2022) presents a

thesis on the importance of the link between the EU countries and candidate countries regarding FDI flows. He concludes that the old EU member states are generally net investors, while the new EU member states, the accession candidates and the new EU candidates (including the Western Balkan countries) are generally net recipients of intra-European FDI. With regard to the EU accession process and the impact on FDI, L. Benfratello, A. D'Ambrosio, A. Sangrigoli and G. Scabbia (2022) analyze the impact that the different phases of the EU accession process (the pre-negotiation phase, the negotiation phase, the approval and actual membership phases) can have on the likelihood of a country in the Balkan region to attract FDI. The authors show that all the phases are associated with positive FDI growth and identify the "expectation effect" that occurs in the approval phase and affects both European and non-European investments. This result emphasizes the importance of both actual and potential EU membership in the decision to invest in the Balkans. The only exception is the negative impact of EU membership on attracting foreign direct investment in the manufacturing sector.

A. Hayat (2019) deals with the question of what role the quality of institutions plays in a country's economic growth, also raising the question of the extent to which the influence of institutions is transmitted to economic growth via the FDI channel. The database used in this paper covers 104 countries and is therefore suitable for the application of the generalized method of moments for dynamic modelling of panel data. Based on the data used in the GMM model, it is concluded that foreign direct investment has a positive impact on economic activity in low- and middle-income countries, whereas it makes a negative contribution in high-income ones. The quality of institutions has a positive effect on economic activity regardless of the income level, but the effect of improving the quality of institutions is more pronounced in low- and high-income countries than in middle-income ones. Finally, the higher quality of institutions further strengthens the positive effect of FDI inflows on economic activity in low- and middle-income countries. In a similar fashion, also using the GMM model, S. Arsov and A. Naumoski (2024) find that the institutional environment plays

an important role in attracting foreign investors in the EU countries, as FDI is significantly higher in the countries with less corruption, more effective governance, and greater trust in the legal system.

Of particular interest is a recent paper (Smolo, 2023) that analyzes the impact of foreign direct investment, institutions and their interaction on the economic activity of the Western Balkans. The author's analysis reveals that foreign investment and institutions have a negative impact on economic growth in the region. When foreign investment is combined with the indicator of institutional development, both factors, including their interaction, show a negative (although not statistically significant) impact on economic growth.

This result closely relates to the topic of institutional arbitrage, which, according to M. Perkmann, N. Phillips and R. Greenwood (2022), refers to "how actors profit from bringing together incompatible institutional logics". Although the term originates from finance, it can be applied more broadly, i.e. to any attempt to capitalize on the existence of differences. As such, it is applicable to the situation presented in the above-mentioned paper, considering the fact that the Western Balkan countries benefit from not having improved their institutional frameworks, whether intentionally or not (which is one of the questions).

The models used in the relevant literature are mostly based on the application of panel methods, whether dynamic or not, while the choice of a specific model for our analysis is largely limited by the characteristics of the database, which are presented below.

## DATA, VARIABLES AND MODEL SPECIFICATION

The modelling of the impact of FDI and institutions on real GDP growth through individual and joint effects is based on the panel database of five countries, the time dimension covering a period of 16 years, and six potential individual explanatory variables (excluding the joint effect). The initial framework of the potential explanatory variables includes the control variables

that are expected to have certain explanatory power in relation to the modelling of the growth of economic activity through the real GDP growth indicator and was selected based on the models evaluated in relevant papers, such as T. Stevanović *et al* (2022) and A. Hayat (2019). In this case, an additional limitation is imposed by a relatively small database, considering the fact that the main objective of the paper is to establish the effect and interaction of the FDI indicators and institutions with respect to the Western Balkan countries. For the aforementioned reasons, the set of potential regressors consists of the indicators of fixed capital formation, government expenditure and the volume of foreign trade through the logarithmic values of the GDP shares as the control variables, then the variables of interest for this particular paper, namely the FDI shares in GDP and a composite measure of institutional quality and their interaction variable (for a detailed description, see Table 1). The group of countries included in the analysis consists of Albania, Bosnia and Herzegovina, North Macedonia, Montenegro, and Serbia.

When preparing the data, the variables were tested for the presence of a unit root using the Im-Pesaran-Shin unit root test (Table 2), which showed that the logarithmized values of the control variables and the untransformed values of the FDI and institution variables were stationary.

The multicollinearity test indicates a potentially statistically significant correlation between fixed capital formation and government spending, which is to be expected to a certain extent given the still significant contribution of government investment to economic growth in the Western Balkan countries. There is also a potentially significant correlation between the trade volume indicators and the other control variables. To examine the overall significance of these correlations in terms of their impact on the model, variance inflation factor (VIF – Table 3) analysis was carried out, based upon the ratio of the variances in the model with multiple regressors versus the model with only one regressor. As with correlation coefficients, there is no consensus on the tolerance threshold for this analysis. Considering the fact that the individual values of this test, as well

**Table 1** The overview of the variables

Variable	Description	Source
GDP	The gross domestic product growth rate.	Eurostat
FDI/GDP	The share of foreign direct investment inflows in GDP.	Eurostat
Fixed investments/ GDP	The share of fixed investments (investment in buildings, machinery, equipment, software, literary and artistic originals, etc.) in GDP.	Eurostat
Government consumption/GDP	The total government spending on goods and services expressed as a share of GDP.	World Bank (2024b)
Trade volume/GDP	The total value of the exports and imports of goods and services expressed as a percentage of GDP.	World Bank (2024b)
Institutions	A composite indicator consisting of the following six indicators:	
Rule of Law	A measure of trust in compliance with rules, especially those related to the implementation of contractual obligations, respect for property rights, trust in the police and courts, as well as the likelihood of crime and violence.	World Bank (2024c)
Control of Corruption	The indicator measuring the extent to which public power is used for private gain, including larger and smaller forms of corruption, as well as the “capture” of the state by elites and private interests. It also measures the strength and effectiveness of a country’s policy and institutional framework for preventing and fighting corruption.	World Bank (2024c)
Regulatory Quality	The perception of the government’s ability to formulate and implement sound policies and regulations that allow and promote the private sector development.	World Bank (2024c)
Government Effectiveness	Perceptions of the quality of public services, the quality of the civil service and its degree of independence from political pressures, the quality of policy formulation and implementation, as well as the credibility of the government’s commitment to such policies.	World Bank (2024c)
Political Stability and Absence of Violence	The perception of the likelihood of political instability and/or politically motivated violence, including terrorism.	World Bank (2024c)
Voice and Accountability	The perception of the extent to which the citizens of a country can participate in the election of their representatives, whether the media are free or not, and whether there are freedoms of expression and association or not.	World Bank (2024c)

Source: Eurostat, World Bank

as the overall value, are between 1 and 5, even if more conservative guidelines are followed, it can be concluded that the problem of multicollinearity is not crucial when modelling these variables. All the control variables show a significant degree of correlation with the dependent variable. On the other hand, the *FDI* and *institutions* variables show a significant degree of mutual correlation, yet no correlation with the dependent variable. The reciprocal correlation between the *FDI* and *institutions* variables may represent an endogeneity problem that can best be solved employing the GMM model. Unfortunately, the available data set is not suitable for such an analysis as the number of available observations is relatively small (80 in the T and N dimensions), which is a “long panel” with the T dimension dominating the N dimension. On the other hand, the correlation

**Table 2** The stationarity test results

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Explanatory variable	Test statistic
Fixed investment/GDP	-3.901 (0.000)
Government spending/GDP	-3.924 (0.000)
FDI/BDP	-3.406 (0.000)
Trade volume/BDP	-4.762 (0.000)
Institutions	-2.01 (0.018)

Notes: The brackets contain the p-values; Ho: The panels contain the unit roots.

Source: Authors

**Table 3** The correlation coefficients and the VIF values

Correlation coefficients	GDP	Fixed investment/ GDP	Gov. spending/ BDP	FDI/GDP	Trade volume/GDP	Institutions	VIF
GDP	1						
Fixed investment/GDP	0.254	1					1.32
Government spending/GDP	-0.518	0.224	1				1.45
FDI/BDP	0.039	-0.050	0.062	1			1.32
Trade volume/BDP	0.644	0.301	-0.421	-0.157	1		1.55
Institutions	-0.060	-0.041	-0.020	0.470	-0.033	1	1.29
							Mean VIF: 1.38

Source: Authors

coefficient of  $<0.5$  is not necessarily problematic, especially in conjunction with the moderately low VIF value (less than 1.5). Against this background, the benefits of applying an appropriate quantitative framework to such limited data somewhat outweigh the risks of endogeneity bias, at least until more data are available to overcome such challenges.

The test for the presence of autocorrelation in the panel using the Wooldridge test also shows a statistically significant autocorrelation in the database, which must be taken into consideration during the modelling phase (the test statistic value of 6.238 and the p-value of 0.066). Taking into account the long structure of the panel ( $T > N$ ), the use of the generalized least squares method is appropriate when modelling panel data, which is particularly useful in the case of autocorrelation, according to D. Hoehle (2007). It is also necessary to check whether heteroscedasticity is present in the data. Considering the fact that the use of the GLS as a method to evaluate the parameters of the panel model certainly yields scores by the maximum likelihood method, it is easy to apply the LR test, which indicates the presence of heteroscedasticity (the test statistic value of 13.81 and the p-value of 0.008). It is therefore a database in which both autocorrelation and heteroscedasticity are present. Finally, it is necessary to perform a test

for cross-sectional dependence. According to R. E. De Hoyos and V. Sarafidis (2006), the structure of the “long” panel (in which the number of the observation units is less than the number of the periods) indicates the use of Pesaran’s CD test for cross-sectional dependence, the results of which are given in Table 4.

**Table 4** The cross-sectional dependence test results

Pesaran’s cross-sectional dependence test	
Explanatory variable	Test statistic
Fixed investment/GDP	3.537 (0.000)
Governemnt spending/ GDP	6.027 (0.000)
FDI/BDP	1.982 (0.048)
Trade volume/BDP	9.637 (0.000)
Institutions	4.449 (0.000)

Notes: The brackets contain the p-values; Ho: Weak cross-sectional dependence.

Source: Authors

It is certain that, when modelling panel data, autocorrelation, heteroscedasticity and the presence of interdependences between the panel units, as well as the fact that it is a panel with a T>N structure, must be taken into consideration. All the above-mentioned limitations can be taken into account using the *xtgls* commands in the STATA program, with which robust (but optimistic) standard errors are obtained (Hoechle, 2007). The following three models are evaluated:

$$Y_{it} = \text{const} + \beta X_{it} + \gamma SDI_{it} + \varepsilon \quad (1)$$

$$Y_{it} = \text{const} + \beta X_{it} + \gamma_1 SDI_{it} + \gamma_2 Inst_{it} + \varepsilon \quad (2)$$

$$Y_{it} = \text{const} + \beta X_{it} + \gamma_1 SDI_{it} + \gamma_2 Inst_{it} + \gamma_3 (SDI_{it} \times Inst_{it}) + \varepsilon \quad (3)$$

where, in all three equations,  $X_{it}$  denotes the matrix of the control variables. In the model (1), the FDI variable is included as an explanatory variable, in addition to the matrix of the control variables; then, the iterations (2) and (3) include the institutional quality variable and their interaction variable, respectively.

## RESULTS AND DISCUSSION

The evaluation results of the suggested model are given in Table 5. The original model (1) contains only control variables, which leads to the conclusion that all the indicators, with the exception of the share of fixed capital formation in GDP, are statistically significant when modelling real GDP growth. As far as the signs of the coefficients are concerned, the indicators for foreign direct investment and the volume of foreign trade have the expected positive sign, as they should have a positive impact on economic growth. On the other hand, the indicator for government spending has a negative coefficient. The literature on the expected impact of government spending on economic activity is not uniform. On the one hand, it is assumed that higher government spending stimulates the economy and thus makes a positive contribution, at least through some of its segments, such as investment in education (Hansson & Henrekson, 1994). On the other hand, an excessively large government sector can have a negative impact on economic activity. There

**Table 5** The model results

The GLS method with the panel-specific autocorrelation of AR(1) type and correction for heteroscedasticity and cross-sectional dependence				
Explanatory variable	(1)	(2)	(3)	(4)
Fixed investment/GDP	3.499 (2.237)	3.387 (2.193)	2.078 (2.363)	
Government consumption/ GDP	-20.556*** (3.730)	-20.021*** (3.769)	-21.341*** (3.856)	-21.208*** (3.790)
FDI/GDP	0.063* (0.038)	0.127*** (0.049)	0.159*** (0.049)	0.138*** (0.043)
Trade volume/GDP	14.342*** (2.493)	15.421*** (2.523)	14.537*** (2.603)	14.872*** (2.403)
Constant	1.656*** (0.559)	0.775 (0.669)	0.739 (0.648)	1.076** (0.552)
Institutions		-2.552** (1.223)	-0.469 (1.547)	
Interaction term			-0.595** (0.261)	-0.569*** (0.184)

Notes: The number of the observations for all the model iterations is 80. The dependent variable in the model is real GDP growth. The Wald test with the null hypothesis of no statistical significance of the included parameters is rejected for all the iterations of the model. \*\*\* The statistical significance of the coefficient at the level of 1%. \*\* The statistical significance of the coefficient at the level of 5%. \* The statistical significance of the coefficient at the level of 10%. The value of the standard error is given in parentheses.

Source: Authors

are numerous reasons for this, such as inefficient investment and excessive social benefits (Kutasi & Marton, 2020). In addition, the fact that the period covered by the database (2007-2022) includes several challenging periods for the Western Balkan countries included in the analysis must also be taken into account. In the period mentioned, the effects of the financial crisis, several weather disasters, the pandemic, and heightened geopolitical tensions were recorded, in which higher government spending was expected to partially neutralize the negative effects mentioned. As government spending is not fully (and sometimes not even mostly) efficient in this endeavor, multiple periods will see weak growth in economic activity, combined with a high share of government spending. Nominally, a longer time series would neutralize the effect of these breaks, but due to their size, distribution and intensity, as well as limited data availability, the database is inevitably affected by this problem.

In the model's second iteration, the impact of institutions on economic activity is included and its contribution is statistically significant. The negative sign of the investment coefficient requires additional clarification. For all the countries except Montenegro, a negative mean value of the institutional variable in the range from -0.08 to -0.36 is recorded. Montenegro records a slightly positive arithmetic mean of 0.08. Out of the 80 observations, only 22 recorded non-negative values for the indicators for institutions, and 15 were recorded in Montenegro.

This result implies a greater positive effect of institutions on economic activity when institutions are rated lower, and the question arises as to how such a result should be interpreted. One of the reasons for such a result could be the absence of a variable that accounts for the effect of convergence to more developed economies (the so-called catch-up effect), when countries with lower standards, income, and growth rates experience stronger growth when favorable policies are implemented. In this case, the institutions would be a proxy for the starting position and its development and would thus show the combined effect of several omitted indicators. For future analyses, it would be useful to explore a similar

form of the model proposed, taking into consideration not only the level of institutional quality but also its change over time, which would better isolate the effects of an improvement in the institutional environment. For the purposes of this analysis, an attempt was made to interpret this result from the perspective of FDI by further refining the model itself.

Therefore, the interaction effect of FDI and the institutional variable is also included in the third iteration. The interaction variable allows the estimation of a part of the influence of the quality of institutions on economic activity through its impact on FDI. In such a specification of the model, the FDI inflow coefficient shows an effect on economic activity when the quality of institutions is ignored, and it is 0.138. The overall effect of the FDI inflow on economic activity can further be decomposed into this direct effect and the effect stemming from institutional quality. To obtain the total effect for an individual country, the average value of the composite indicator for the quality of institutions needs to be calculated. Using Serbia as an example, it can be seen that the average value of the quality of institutions indicator is -0.12. The effect of FDI can thus be broken down into a direct effect, defined by the FDI variable coefficient, and an indirect effect, which is the product of the interaction coefficient and the average value of the institutional quality indicator, i.e. 0.068. Thus, the overall effect of FDI on the GDP growth rate is not 0.138, but 0.206. Interestingly, when the indirect effect of institutions through the FDI channel is identified, institutions no longer have a statistically significant direct effect on GDP growth. A similar result was presented in A. Hayat (2019), although the statistical significance is not lost, only the value of the coefficient decreases with the investment indicator, which is expected due to the isolation of the effect manifested by the FDI channel.

The result obtained in the third and final iteration of the model can help us to some extent to identify possible reasons for the negative sign of the coefficient of institutions, as the effect of "more favorable bad institutions" is now manifested through the FDI channel, while the direct effect on economic activity is statistically insignificant. Similar to the direct effect,

the explanation could lie in a more favorable climate for foreign investors when developing and emerging countries are concerned. As A. Dorakh (2022) shows, new member states and countries in the process of joining the EU tend to be the net recipients of foreign direct investment, not only because of a potentially higher return on investment, lower competition and lower costs, but also because of the relationships established between the two countries, the investors and the host country.

There is another perspective on this result that calls into question investors' motivations and implies a significantly different interpretation of the results. In the analysis made by A. Pavlović M. Njegovan, A. Ivanišević, M. Radišić, A. Takači, A. Losonc and S. Kot (2021), the Balkan countries are characterized as a safe haven for foreign polluters, and they conclude that their "weaker" environmental legislation attracts, among other things, foreign direct investment, which, together with economic growth, brings negative externalities (e.g. pollution) with it. Interestingly, Montenegro stands out from this group of countries (which includes Slovenia, Greece, Bulgaria, Croatia, and Romania, in addition to the Western Balkan countries) as a country with excellent environmental legislation, which has contributed to its characterization as a bearer of the "environmental halo". This is in line with the results of this model and the lower contribution of foreign direct investment to economic activity when the indirect effect of institutions in the Montenegrin economy is taken into account. From this perspective, the lack of regulation and efficiency in law enforcement, a greater tendency towards corruption, and the lack of accountability are the reasons for investing in the Western Balkan countries, which would have a positive effect on economic activity (in the short run). This finding is to a certain extent similar to the finding of E. Smolo (2023), where the author suggests improving infrastructure and making necessary economic adjustments as an appropriate measure to attract more foreign investment, which in turn would support the development of institutions and infrastructure. Our recommendation to overcome the above challenges implies attracting better quality FDI rather than its quantity. A similar finding on the impact of

institutions on economic activity can be found in N. Alimi and L. B. Dhiab (2023), in whose study the results of the panel analysis point to the negative relationship between economic growth and the quality of institutions. However, they also emphasize that such a result should not deny the importance of quality institutions for long-term economic progress, but points to the importance of creating an appropriate environment in which it is possible for institutions to improve, and such an improvement is not made at the expense of economic growth. Even if reference is made to the paper by L. Benfratello *et al* (2022), in which the EU accession process is associated with growth in FDI inflows, manufacturing is the only exception. If the EU accession process is treated as identical to the improvement of the institutional environment, this means that such a process is undesirable for investors in the manufacturing industry (as it has the greatest pollution potential) and its share is the largest in the Western Balkan countries. In addition, some previous analyses (Estrin & Uvalić, 2016) point to a lack of spillover effect when FDI in manufacturing in the Western Balkans is concerned, i.e. there is no statistically significant increase in value added, employment or exports in manufacturing, and, among other causes, they cite the institutional environment of the countries mentioned as a possible one. To test whether the results presented in this paper hold across all industries, it would be beneficial to use the disaggregated categories of FDI instead of gross FDI as the variables, which would represent a valid improvement to the model. Qualitatively, it is worth noting that the manufacturing, construction, and mining industries accounted for over 60% of the total FDI inflow in Serbia from 2021 to 2023 (National Bank of Serbia, 2024), which was only over 30% in North Macedonia (National Bank of the Republic of North Macedonia, 2024), and slightly more than 40% in Bosnia and Herzegovina (Central Bank of Bosnia and Herzegovina, 2024). The data are only available for these countries. Manufacturing dominates in all three, although the overall industrial structure varies significantly, making quantitative testing essential for obtaining meaningful results. Unfortunately, as data become even more limited when disaggregated by industry, such testing would be very challenging to perform.

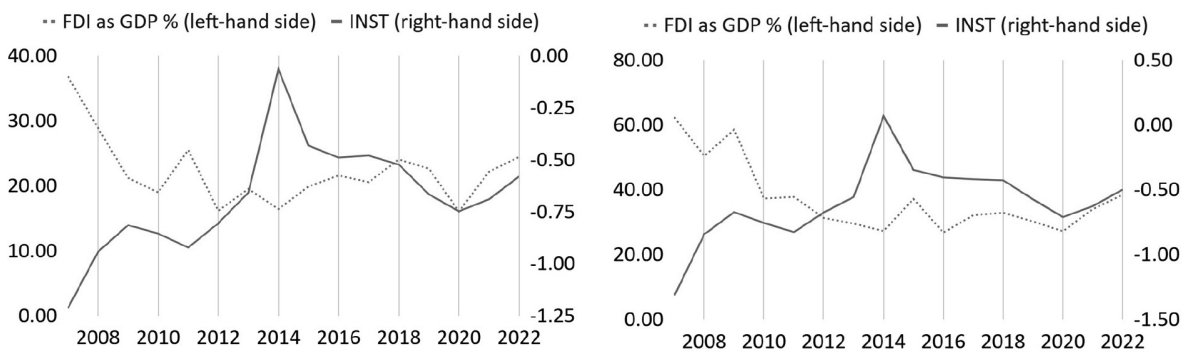
The plotting of the variables in the graph reveals that the counterintuitive relationship between FDI and institutional quality appears to have been weakening over the past few years. However, this observation should be interpreted with caution, as the period was largely influenced by the effects of the COVID-19 pandemic. Nevertheless, there may be a shift emerging in the Western Balkan countries – the one supportive of both increased FDI attraction and institutional advancement.

The findings of this paper suggest that a partial adjustment needs to be made towards attaining a more sustainable future, with a regulatory framework positioning the Western Balkan countries better so as to attract “greener” investors. Steps towards such a solution may have already been made. According to J. Jung (2020), any policy change in one country may have considerable repercussions for the sustainability of all surrounding countries. Given the fact that Montenegro has been diligent in repositioning itself as a sustainable beacon in the Western Balkans, spillover effects on the rest of the region can be expected to materialize. Bearing in mind the fact that all the aforementioned countries are on the path to European Union membership, it can reasonably be expected that bringing regulations in line with the EU may speed up the necessary adjustments regarding FDI as well. Another potential policy regulation which could be adapted from X. Wang

and Y. Luo (2020) implies that the government should strengthen its efforts to raise public awareness of environmental protection objectives, emphasize the importance of environmental oversight, and uphold strict pollution controls for businesses through a combination of economic, administrative, and legal measures. Any policy recommendation must include the enhancement of environmental regulatory frameworks and the improvement of the ecological evaluation of foreign investments through effective and adaptive monitoring mechanisms.

### CONCLUSION

Economic theory suggests that, considered individually, foreign direct investment inflow and the quality of institutions have a positive effect on a country’s economic growth. Further consideration would lead us to argue that their interaction must undoubtedly have a positive effect on economic activity. However, as the debate on the potential and/or actual impact of FDI on the real and long-term growth and development of countries is still ongoing, this study has analyzed the issue of the relationship between FDI and economic growth which is still controversial by examining the impact of the different quality of institutions on this relationship. The models analyzed aim to better understand the impact of these



**Graph 1.** FDI as GDP % and institutional quality, the Western Balkan countries, excluding Montenegro (on the left-hand side), and including Montenegro (on the right-hand side)

Izvor: Obračun autora na osnovu World Bank (2024a) i World Bank (2024c)

variables in the Western Balkans, a region that is difficult to model due to its challenges and complexity. To evaluate the panel model, the generalized least squares method was used in the STATA program, with correction for autocorrelation, heteroscedasticity, and cross-sectional dependence. All the iterations of the model (with the effect of FDI only, with the effect of FDI and the quality of institutions, and with the effect of the variables mentioned and their interaction) are statistically significant. The results of the panel model confirm the statistical significance and the positive effect of the inflow of FDI on the GDP growth rate of the Western Balkan countries. This positive effect is reinforced when the institutional environment is taken into account, which confirms all the three hypotheses put forward in this paper's introduction. However, the direction, i.e. the interpretation of the correlations mentioned, does not correspond to the original expectations, bearing in mind that the result implies a positive effect of a qualitatively poorer institutional environment on economic activity through the foreign direct investment channel. One of the explanations for this (somewhat unexpected) result is the thesis that "weaker" legislation (especially in the environmental field) in the Western Balkan countries attracts foreign direct investment, which, apart from helping economic growth, leads to pollution and makes the countries of the region a safe haven for foreign polluters. The fact is that the growth based on such foundations is short-lived and further analyses are needed to deepen or refute the thesis presented. There are numerous ways to improve the analysis conducted in this paper primarily based on the inclusion of dynamic categories through the indicator change variables, the identification of the influence of the individual indicators of institutions (not only the overall mean indicator), and the identification of the variables that can effectively isolate the environmental effect of the current inflow of foreign direct investment on the Western Balkan region. The challenges of adapting some of them have been discussed more deeply in the paper (such as the GMM estimation and FDI disaggregation). Certainly, more complex analyses require more extensive databases, and the topic discussed in this paper will be another in a series that will benefit

from longer, consistent and harmonized time series of both macroeconomic and alternative indicators of economic activity and its drivers in the future. As numerous studies have consistently shown, the benefits of sound institutions are substantial, while the short-term gains arising from weak institutional frameworks rarely outweigh long-term advantages. The potential shift suggested by recent trends is promising but has yet to fully materialize, which it is unlikely to do without a sustained commitment to institutional improvement, especially in the long run.

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