The impact of EU candidate status on the inflow of foreign direct investment

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Bachelor Thesis

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Bachelor Project: International Cooperation and the Design of Global Economic Institutions

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May 21, 2021

7622 words

Introduction

In recent decades, foreign direct investment (FDI) has become an important vehicle of development. Competition to attract FDI inflows directed significant scholarly and policy attention to identifying the main factors that influence the level of FDI flow to recipient states, especially developing economies (see Bénassy-Quéré et al., 2007; Büthe & Milner, 2008; Mottaleb & Kalirajan, 2010) and economies in transition (see Bevan & Estrin, 2004; Kinoshita & Campos, 2003; Resmini, 2001).

The core problem associated with FDI is that liquid investment turns mostly illiquid once it enters a host country. In other words, capital turns into factory buildings, accompanying infrastructure and machinery. Due to large sunk costs of FDI, investors pay particular attention to the political risk of expropriation, transfer and war in a host country (Graham et al., 2016). Thus, investors are more likely to move capital either to countries where the political risk is low or to countries that are constrained by some international institutions. To reassure potential investors, states have used the following international institutions as credible commitment mechanisms: bilateral investment treaties (Desbordes & Vicard, 2009; Egger & Merlo, 2007), international trade agreements (Büthe & Milner, 2008) and memberships in reputable international organizations (Dreher & Voigt, 2011).

Specifically, scholars have found a significant positive the effect of EU accession prospects on FDI inflows for previous enlargements (Bevan & Estrin, 2004; Claessens et. al, 1998; Gungor & Bintali, 2010; Kaminski, 2001). Despite significant empirical evidence on the effect, the mechanism behind the effect remains contested. That said, this thesis seeks to answer the following research question:

How does EU candidate status impact the inflow of foreign direct investment?

The thesis has two distinct objectives. First, bearing in mind the slowdown in the EU accession process and changes in the Enlargement Methodology (Miščević & Mrak, 2017), I examine whether the effect of EU candidate status on FDI flows is still present. Second, the thesis analyses two contested mechanism behind the effect – “EU-induced reform” and “perception change”.

To achieve the stated objectives, a Most Similar Systems Design is used. Serbia and Belarus are selected based on theoretically relevant similarities such as the communist legacy, size of the economy, labour costs and investment policies. The two cases differ on the independent variable, the EU accession process. Serbia has been a candidate country since 2012, while Belarus has not expressed interest in EU Membership. The timeframe for this study is between 2009 and 2019. The year 2009 is selected since it represents the very beginning of Serbia's accession process, the formal application for membership. The same year, Belarus has signed the Eastern Partnership, a joint initiative between the EU and six Eastern European states.

Based on the analysis it can be concluded that the prospect of EU membership has a positive effect on FDI flows to candidate countries. Since it was granted candidate status in 2012, Serbia's inward direct investment has been increasing every year. In contrast, the inward direct investment to Belarus has been marginally declining since 2013 and stagnating since 2016. As to the mechanism behind the effect, the findings suggest that foreign investors pay less attention to the actual reforms in candidate states than to the EU announcements on it.

This thesis contributes to the literature on the impact of membership in international institutions (Dreher & Voigt, 2011), literature on institutional determinants of FDI (Ali et al., 2010; Buchanan et al., 2012; Busse & Hefeker, 2007; Kinoshita & Campos, 2003), and literature on FDI in transition economies (Bevan & Estrin, 2000; Kinoshina & Campos, 2003; Resmini, 2000). What is more, it engages with and challenges the literature on the effectiveness of EU conditionality (Dimitrova & Pridham, 2004; Schimmelfennig et al., 2003).

The remainder of the thesis proceeds as follows. It starts by outlining the literature on the determinants of FDI, focusing on the role of domestic and international institutions in attracting FDI. Section "Methodology" provides an in-depth overview of the research design, selected cases and data. The thesis proceeds by analysing the effect in question and testing two rival explanations behind the effect. Lastly, section "Discussion and Conclusion" presents the main findings, links them to the existing literature and proposes avenues for further research.

Theoretical Framework

Foreign Direct Investment

The extensive literature on FDI can be broadly divided into literature that focuses on the effects of FDI on recipient countries (see Blomström et al., 2005; Forte & Moura, 2013; Jude & Levieuge, 2017) and literature that explores the determinants of FDI flows (see Bevan & Estrin, 2004; Campos & Kinoshita; 2003; Du et. al., 2007; Yu & Walsh, 2010). The latter will be of interest for this thesis.

The literature on FDI determinants identifies several factors in recipient countries that influence the inflows of FDI, depending on the type of FDI. First, market-seeking FDI, also known as horizontal FDI involves opening identical production facilities with a purpose of serving a host country's market and regional markets. Here, macroeconomic variables such as the market size and market growth are considered to be the main determinants of FDI (Campos & Kinoshita, 2003; Mottaleb & Kalirajan, 2010). With globalization, however, "one of the most important traditional FDI determinants, the size of the national markets has decreased in importance" (UNCTAD, 1996, p. 97). Second, asset-seeking FDI, also known as vertical FDI involves relocating certain stages of production with the aim of acquiring resources such as cheap labour, natural resources and raw materials. In this case, the availability of low-cost labour and/or natural resources is considered to be the primary determinant of FDI (Campos & Kinoshita, 2003; Mottaleb & Kalirajan, 2010). Third, efficiency-seeking FDI involves economies of scale and scope (Campos & Kinoshita, 2003). One of the main considerations related to efficiency-seeking FDI is the ease of doing business, i.e. the regulatory environment of a host country (UNCTAD, 1996, p. 97). This, in turn, depends on institutions.

The interest in the effect of institutions on economic performance has been sparked by Douglass North's *Institutions, Institutional Change and Economic Performance.* In this book, North (1990) argued that institutions determine the performance of economies. He defined institutions as "the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction" (North, 1990, p. 3). While institutions are the rules governing the game, organizations are the agents playing the game (North, 1990, p. 4). The following sections review in turn the literature on domestic and international institutions as determinants of FDI.

Domestic Institutions

Since 1990s, the link between domestic institutions and FDI has received significant scholarly attention (Ali et al., 2010; Buchanan et al., 2012; Busse & Hefeker, 2007; Kinoshita & Campos, 2003). Most studies consider institutions to be a robust predictor of FDI. For instance, Daude and Stein (2007) find a positive relationship between the quality of institutions and FDI. Likewise, Bevan et al. (2004) find that foreign investors attach importance to institutional quality in a host country.

The volume of literature on institutional determinants complicates the task of providing a systematic review. That said, only variables that are particularly relevant for transition economies are discussed here. First, one of the core problems in transition economies is corruption (Iwasaki & Suzuki, 2012), which is defined as "the abuse of entrusted power for private gain" (Transparency International, n.d.). The empirical literature has found a negative effect of corruption on FDI inflows (Mauro, 1995; Wei, 1997). This is not surprising, considering that corruption increases uncertainty and costs of doing business (Mengistu & Adhikary, 2011). Second, regulatory quality is the government ability to formulate and implement market-friendly policies. As such, it is important indicator of the progress transition economies make from a centrally planned to a market economy. Intuitively, good regulatory quality increases inward FDI (Fazio & Talamo, 2008). Third, studies on government effectiveness, defined as the quality and independence of public and civil service, find a positive and statistically significant effect on FDI (Bénassy-Quéré et al., 2005; Buchanan et al., 2012). In sum, the quality of domestic institutions is an important precondition for attracting FDI. Even so, the following section shows that countries have found ways to work around domestic deficiencies. The solution to reduce risk was found in international institutions.

International Institutions

One of the core tenets of liberal institutionalism is that international institutions reduce uncertainty (Axelrod, 1981; Keohane, 1984; North, 1990). In the case of FDI, trade agreements (Büthe & Milner, 2008) and bilateral investment treaties (Busse et al., 2010; Desbordes & Vicard, 2009; Egger & Merlo, 2007) are the primary institutions that reduce political risk by constraining a host country from exploiting multinational companies (MNCs). This strand of literature has put forward several noteworthy conclusions. For instance, examining how international institutions impact FDI inflows to developing countries, Büthe and Milner (2008) have concluded that developing countries can use membership in World Trade Organization (WTO) or Preferential Trading Arrangements (PTA) to show commitment to liberal economic policy. Importantly, membership in one institution can have effects in areas other than the issue area of that institution (Büthe & Milner, 2008). Similarly, Dreher and Voigt (2011, p. 329) state that "membership in IOs can be used by nation state governments to signal their commitment to follow certain policies". Scholars have also examined the effect of specific international organizations such as the EU, which will be presented next.

The impact of EU membership on FDI flows has received fair scholarly attention (Bevan & Estrin, 2004; Blomström & Kokko, 1997; Campos & Kinoshita, 2003; Claessens et al., 1998; Gungor & Bintali, 2010; Kaminski, 1998). Investigating "How much additional FDI does a country receive as a consequence of being a member of the EU?", scholars have found that EU membership increases FDI inflows by about 28% (Bruno et al., 2016). The interest of this thesis is however not the effect of full EU membership, but EU candidate status. The literature on the impact of the prospect of EU membership finds solid empirical support demonstrating that EU candidate countries attract more FDI compared to non-candidates. For instance, Kaminski (1998, p. 40) finds a significant difference in FDI inflows between Central and Eastern European countries during the EU accession period and countries of the Commonwealth of Independent States. The author argues that it is precisely the "EU factor" that explains higher FDI inflows to candidate states.

Despite the consensus on the positive effect of EU candidate status on FDI inflows, the mechanism behind this effect is contested. The first strand of literature explains that the prospect of EU membership affects FDI inflows to candidate states through domestic policy change. For instance, Kaminski (1998, p. 40) argues that the policy-induced EU integration was decisive in attracting FDI to Central and Eastern European countries. This line of reasoning is backed up by the literature on EU conditionality. Simply put, EU conditionality is a mechanism that incentivizes political elites to transform domestic institutions in return for EU membership (Bieber, 2011). In order to obtain full membership, states go through several phases. Importantly, each step in the process is merit based: first, a country submits an application to the European Council, which must be followed by an unanimous decision of the EU Member States to grant the official candidate status (European Commission [EC], 2016). The candidate status is not a guarantee of formal opening of the accession negotiations. The start of negotiations is itself contingent on the fulfilment of certain conditions. Once opened, the accession negotiations cover 35 negotiating chapters, which are opened and closed based on interim and closing benchmarks (EC, 2016). In other words, EU membership is contingent on fulfilling the stringent criteria, also known as the Copenhagen criteria (Dimitrova & Pridham, 2004). The Copenhagen criteria include: "stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities; a functioning market economy and the ability to cope with competitive pressure and market forces within the EU; ability to take on the obligations of membership, including the capacity to effectively implement the rules, standards and policies that make up the body of EU law (the 'acquis'), and adherence to the aims of political, economic and monetary union" (EUR-Lex, n.d.). Once fulfilled, the country signs the EU Accession Treaty (EC, 2016). In sum, the first proposed mechanism explaining the effect of EU candidate status on FDI is the following. EU accession conditionality pushes candidate states to undergo reforms. EU-induced reforms improve the institutional quality of a candidate country, hence increasing FDI inflows. For the purpose of this thesis, this mechanism is labelled "EU-induced reform"

The second strand provides a different explanation of the mechanism through which the prospect of EU membership impacts FDI flows to candidate states and can be labelled "changing perceptions". The logic behind the second mechanism is that the announcements about prospects of EU membership reduce risk in the eyes of investors, increasing FDI inflows (Bevan & Estrin, 2004). The most comprehensive theory, "theory of the company states keep" is put forward by Gray (2013). The theory argues that membership or allegiance to international institutions changes perceptions of country risk and its future behaviour, no matter what the organization asks its members to do or change. Membership or candidature is easily observable, unlike the implementation of domestic reforms. "Investors react most strongly when Brussels signs off on policy reforms in accession countries – not when those countries actually implement those reforms" (Gray, 2013, p. 190). In other words, surrounded by conflicting, imperfect information, investors treat international organization as a determinant of the trajectory of a candidate country. The author further argues that the reputation of the international institution matters, making a distinction between good and bad company associations. The European Union falls under the category of "good company associations". Gray (2013) argues that the reputation of members in "good company associations" spills over into perception of other members. In contrast, the Eurasian Union falls under the category of "bad company associations", since its members have high levels of political risk. Thus, the mechanism behind a "bad company association" works against the new member (Gray, 2013).

In light of the disagreement on the mechanism behind the studied effect, this thesis proposes and tests two rival explanations. Based on the literature on institutional determinants of FDI and EU conditionality, it can be assumed that foreign investors react to institutional improvements in candidate states during the EU accession process:

H1: *Foreign direct investment increases as a result of improved institutional quality during the EU accession process.*

Based on the literature on the psychological effects of association with an international organization and the "theory of the company states keep", a rival assumption in this thesis is that actual reforms matter less than the change in investor perceptions. A second hypothesis is put forward:

H2: *Foreign direct investment increases as a result of the EU signalling about the trajectory of the candidate country.*

Conceptualization

In the literature, FDI is simply defined as "an investment in which the investor acquires substantial controlling interest in a foreign firm or sets up a subsidiary in a foreign country. FDI involves ownership and/or control of a business enterprise abroad" (Markusen et al., 1995, p. 394). For practical purposes, the conceptualization of FDI and FDI flows follows the definition of the United Nations Conference on Trade and Development (UNCTAD), which is the main source of FDI data. "FDI is defined as an investment reflecting a lasting interest and control by a foreign direct investor, resident in one economy, in an enterprise resident in another economy (foreign affiliate)" (UNCTAD, n.d.). Specifically, FDI flows "comprise capital provided by a foreign direct investor to a foreign affiliate, or capital received by a foreign direct investor from a foreign affiliate" (UNCTAD, n.d.).

Considering the complexity of institutions, defining institutional quality is rather challenging. For practical purposes, institutional quality and governance are oftentimes closely linked in the literature. Huther and Shah (1998) linked the concept of governance to the concept of institutions by defining governance as "all aspects of the exercise of authority through formal and informal institutions" (Huther & Shah, 1998, p. 2). Kaufman et al. (2010) provide a more comprehensive definition: "governance consists of the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them" (p. 3). Given that the emphasis of this thesis is on the adoption on policies, institutional quality is defined here as "the capacity of the government to effectively formulate and implement sound policies and provide public services" (Kaufman et al., 2010, p. 3).

Methodology

Case Selection

To analyze the effect of the EU candidate status on FDI, a comparative research is conducted. Specifically, a Most Similar Systems Design (MSSD) is used. The core idea of the MSSD is to select cases that share many theoretically significant characteristics, yet differ on the independent variable (Halperin & Heath, 2017, p. 219). Then, the shared characteristics act as control variables and cannot explain the variation in the dependent variable (Porta, 2008, p. 214; Halperin & Heath, 2017, p. 219).

The selected cases are Belarus and Serbia. The two countries have comparable economies and comparable investment policies, but differ on the independent variable – the EU accession prospect. To avoid the omitted variable bias, which occurs when one fails to include important factors (Halperin & Heath, 2017, p. 220), relevant characteristics are grouped in five categories: history, geography, size of the economy, investment policies and treaties. Each of the categories, which greatly differ in their importance and specificity, will be discussed in turn.

First, both Belarus and Serbia are post-communist countries. Belarus is a former Soviet republic that declared independence in 1991 (French et al., 2021). Serbia is a former Yugoslav republic. It is a stand-alone republic since 2006, when Montenegro declared independence from the Union of Serbia and Montenegro (Lampe et al., 2020). Second, Belarus and Serbia are landlocked countries in Europe and border both EU and non-EU Member States (French et al., 2021; Lampe et al., 2020).

Third, both countries are considered transition economies by UNCTAD and their economies are comparable in size. As seen from Table 1 on the next page, Serbia's GDP in 2019 was $51.457 billion. Belarus's GDP for the same year was higher, reaching $63.08 billion (World Bank, 2019). When expressed as GDP per capita, Serbia fares slightly better, with $7,411 compared to $6,663 in Belarus (World Bank, 2019). What is more, national income in Serbia and Belarus is comparable, $5,709 and $5,153 respectively (World Bank, 2019).

Table 1

Comparison of macroeconomic data: Serbia and Belarus

	Serbia	Belarus
GDP (2019)	USD 51.457 billion	USD 63.08 billion
GDP per capita (2019)	USD 7,411	USD 6,663
Adjusted net national income per capita (2018)	USD 5,709	USD 5,153

Note: Adapted from World Bank, 2019.

The investment conditions and policies of the two countries are also comparable. As seen in Table 2, corporate profit tax in Serbia is slightly more favorable than in Belarus, 15% (Development Agency of Serbia [RAS], 2019) and 18% (National Agency of Investment and Privatization [NAIP], 2019) respectively. Value added tax (VAT) is 20% in both countries (RAS, 2019; NAIP, 2019). As of 2019, Belarus had 70 effective Double Taxation Treaties (NAIP, 2019), while Serbia had 54 (RAS, 2019).

Table 2

Comparison of Investment Policies and Treaties: Serbia and Belarus

	Serbia	Belarus
Corporate Profit Tax	15%	18%
Value Added Tax	20%	20%
Double Taxation Treaties	54	70
Bilateral Investment Treaties	47	56

Note. The data for Belarus are from “Invest in Belarus Guidebook”, by NAIP, 2019. The data for Serbia are from “Why Invest in Serbia”, by RAS, 2019. The data on Bilateral Investment Treaties are from “Investment Policy Hub” by UNCTAD, n.d.

What is more, both countries offer significant financial benefits and incentives to foreign investors. In the case of Belarus, foreign companies operating in one of the six Free Economic Zones benefit from a privileged legal regime in the first seven years from registration. In particular, companies are exempt from Corporate Income Tax, Real Estate Tax, Ground Rent, Land Value Tax, Custom Duties, as well as work and residence permit fees (NAIP, 2019). In the case of Serbia, financial Benefits and incentives include Construction Land Transfer Subsidy, a 10-year Corporate Income Tax Relief (for investments over 8.5 million euros and 100 employees). Also, there are 15 free zones in Serbia, which offer custom and fiscal benefits (RAS, 2019).

Lastly, the number of Bilateral Investment Treaties (BITs) can act as a control, since it does not differ substantially. As of 2019, Serbia has 47 BITs in force. Out of 47 BITs Serbia has concluded 23 are with EU Member States. Meanwhile, Belarus has 56 BITs in force, 19 of which are concluded with EU Member States. Both countries have BITs with Azerbaijan, Bosnia and Herzegovina, China, Egypt, Iran, Israel, Kuwait, North Macedonia, Turkey, Switzerland, United Arab Emirates, and the United Kingdom (UNCTAD, n.d.). This suggests that more than 30 Serbian and Belarusian BITs cover the same countries.

Having identified control variables which cannot explain the variation in the dependent variable, this section turns to the variation on the independent variable, the prospect of EU membership. Serbia has been a candidate country since 2012. As of 2020, it has opened 18 out of 35 negotiating chapters, two of which are provisionally closed. A full list of opened negotiating chapters with opening dates can be found in the Appendix. On the other hand, Belarus is not a candidate country. However, the country is part of the Eastern Partnership.

Besides theoretically-relevant similarities of Belarus and Serbia and variation on the independent variable, the two cases are also interesting from a policy perspective. After placing second in 2017, Serbia has topped the Greenfield FDI Performance Index in 2018, with 107 greenfield projects (Barklie, 2019). Its score of 11.92 indicates that Serbia has attracted close to 12 times the amount of FDI compared to other economies of its size (Barklie, 2019). In contrast, having attracted only 27 greenfield investments in 2018 Belarus ranked 41st. What makes this outcome surprising, apart from the outlined similarities, are World Bank Ease of doing business rankings for the two countries. Namely, in 2018, Belarus ranked 37th, while Serbia ranked 48th (World Bank Group, 2019). The counter-intuitiveness of this empirical observation is yet another reason for selecting the two cases.

Data and Operationalization

Institutional Quality

This study focuses on three dimensions of institutional quality: corruption, regulatory quality and government effectiveness. The three indicators come from two different sources. For the first institutional variable, corruption, Transparency International's Corruption Perception Index (CPI) is used. This index measures how corrupt public officials and politicians are perceived to be. Until 2012, CPI ranged from 0 (the highest level of perceived corruption) to 10 (no corruption). Since 2012, CPI ranges from 0 (the highest level of perceived corruption) to 100 (no corruption). Commenting on the updated methodology, Transparency International (2012) stresses that "scores from the CPI 2011 and previous editions should not be compared with scores from 2012". With that in mind, CPI is analysed only for the period between 2012 and 2019. To compensate for this methodological issue, CPI ranks are presented for the entire period.

For two other institutional variables, Government Effectiveness and Regulatory Quality, World Governance Indicators (WGI) dataset by Kaufmann et al. (2010) is used. In total, the dataset contains six indicators, i.e. six dimensions of governance: Voice and Accountability, Political Stability and Lack of Violence, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. Considering that the analysis focuses on policy reform, only indicators on to the ability of the government to formulate and implement policies (i.e. Government Effectiveness and Regulatory Quality) will be taken into consideration. Government Effectiveness Index captures "perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies" (Kaufmann et al., 2010, p. 4). Regulatory Quality Index reflects "perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development" (Kaufmann et al., 2010, p. 4). Table 3 lists individual indicators on which the two aggregate indicators are based. Both aggregate indices range from -2.5 (weak) to 2.5 (strong). This dataset has been previously used in empirical studies on the effect of institutions on FDI (see Daude & Stein, 2007; Globerman & Shapiro, 2002; Hausmann & Fernández-Arias, 2000; Sabir et. al, 2019).

Table 3

A list of individual indicators

Aggregate Indicators	Individual Indicators
Regulatory Quality index	Discriminatory taxes, Burden of government regulations, Prevalence of non-tariff barriers, Extent of market dominance, Investment freedom, Financial freedom, Ease of starting a business, Ease of setting up a subsidiary for a foreign firm, Share of administered prices, barriers to entry for new competitors in markets for goods and services, Efficiency of competition regulation in the market sector, Investment profile, Regulatory burden, Tax inconsistency
Government Effectiveness index	Infrastructure disruption, State failure, Policy instability, Quality of and Satisfaction with bureaucracy, infrastructure, primary education

Note: Adapted from "World Governance Indicators" by World Bank, n.d. (https://info.worldbank.org/governance/wgi/Home/Documents)

FDI: Flows and Sources

Data on Serbia's and Belarus's inward FDI flows is found in UNCTAD World Investment Reports. FDI flows are given in millions of US dollars. To analyse top five sources of FDI, this thesis relies on US Climate Investment Statements. The data from the Statements is checked against IMF data on Inward Direct Investment Positions.

Analysis

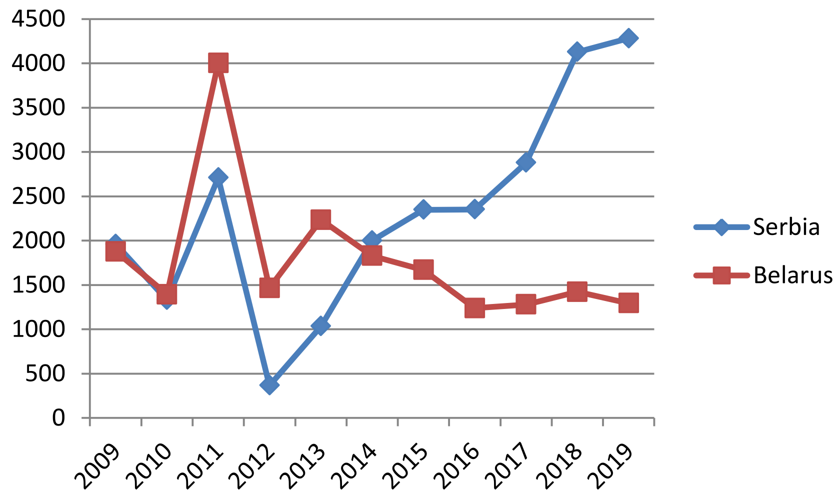
The empirical analysis proceeds in three stages. First, the effect of EU candidate status on FDI is tested against the data. The analysis proceeds with the investigation of the first mechanism "EU-induced reform", by comparing changes in the levels of corruption, regulatory quality and government effectiveness in Serbia and Belarus between 2009 and 2019. Lastly, documents published by the EU and State Department are analysed with the aim of testing the second mechanism, "perception change".

5.1 Foreign Direct Investment

In assessing the effect of the prospect of EU membership on FDI flows, the analysis begins by comparing FDI flows to Serbia, a candidate country and Belarus, which is not a candidate country. As explained in length, the two countries are two comparable economies with comparable investment policies. As seen from Figure 1, in 2009 and 2010, FDI inflows to Serbia and Belarus were almost identical (1959 million US dollars and 1877 million US dollars in 2009; 1393 million US dollars and 1329 million US dollars, respectively). This coincidental convergence represents a good starting point for the analysis of FDI trends that occurred over the following decade.

Figure 1

FDI inflow in US Dollars, Millions



Note: Adapted from "World Investment Report 2019" by UNCTAD, 2019 (https://unctad.org/webflyer/world-investment-report-2019)

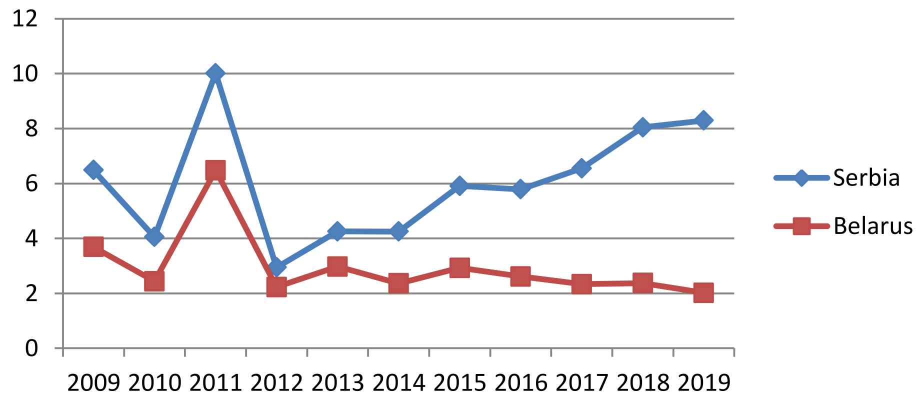
Due to its high volatility, identifying trends in FDI flows can be challenging. In this case, apart from data for 2011 which represent an outlier in both cases, general trends are easily observable. From 2012 onwards, inflow of FDI to Serbia has been steadily increasing, reaching an all-time high of 4281 million US dollars in 2019. In contrast, inflow of FDI to Belarus has had a downward trend in the period between 2013 and 2016. From 2016 onwards, one can speak of stagnation, rather than decline.

In relative terms, following convergence in 2009 and 2010, Belarus had higher FDI inflows for three years in a row. In 2014, FDI inflows into Belarus and Serbia have again converged. Since 2015, FDI inflows to Serbia have been significantly higher. To illustrate the magnitude, in 2018 and 2019, Serbia has attracted more than three times FDI Belarus has received.

To account for slight difference in the sizes of two economies, Figure 2 illustrates FDI flows as percentage of GDP for Belarus and Serbia. It is evident that FDI flows as the percentage of GDP have been higher in Serbia even prior to the EU accession process. Nevertheless, in the period between 2009 and 2012, the percentages in two countries varied in a similar way. Since 2013, the divergence in the data is observed. Interestingly, the start of divergence in 2013 coincides with the start of Serbia's EU accession process, that is its official candidate status.

Figure 2

Foreign direct investment, net inflows as % of GDP



Note: Adapted from World Bank

In short, the findings indicating that Serbia's FDI inflows have been increasing since 2012, while Belarus's have been declining or stagnating confirm the effect of the prospect of EU membership on FDI flows.

Sources of Inward Direct Investment

This section briefly analyses the sources of FDI into the two countries over time, with the aim of investigating whether being EU candidate state alters the origin of FDI. In other words, do candidate states see an increase only in FDI from the EU, or also third countries?

Figure 7 illustrates the share of FDI coming from top 5 sources of investment in 2009, which are the Netherlands, Austria, Cyprus, Greece and Slovenia. These five countries accounted for 61% of inward FDI. Figure 8 illustrates the share of FDI coming from top 5 sources of investment in 2019. The top 5 sources of FDI, the Netherlands, Austria, Cyprus, Germany and Slovenia, accounted for 52% of total. The cross-time comparison sheds light on two developments. First, EU Member States have been and have remained the major source of investment to Serbia. Second, the sources of investment to Serbia have slightly diversified.

Figure 7

Sources of Inward Direct Investment to Serbia 2009

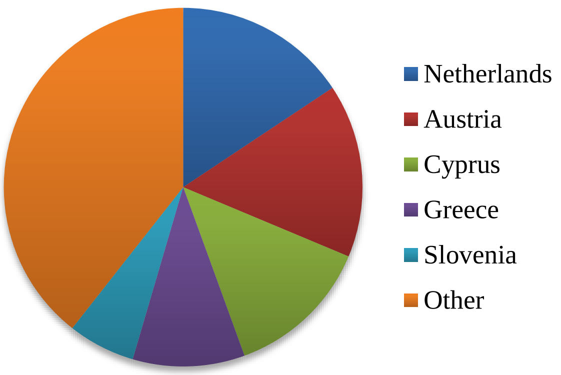
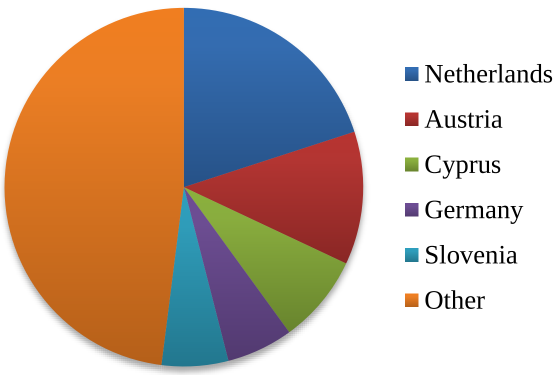


Figure 8

Sources of Inward Direct Investment to Serbia 2019



Note: Data derived from "2009 Investment Climate Statements: Serbia" by State Department, 2009 (https://2009-2017.state.gov/e/eb/rls/othr/ics/2009/117154.htm) and "2019 Investment Climate Statement – Serbia" by State Department, 2019 (https://www.state.gov/reports/2019-investment-climate-statements/serbia/)

The change in the origin of FDI to Belarus can be seen below. In the period between 2009 and 2019, Russia's share of Belarus's total FDI has increased from about 33% to 55%. In other words, Russia alone accounts for more than a half of inward direct investment. What is also worrying is the fact that top 5 sources of investment accounted for 70% of total inward direct investment in 2009 and 80% in 2019. It can be said that, in contrast to Serbia, Belarus has become more dependent on its top sources of investment.

Figure 9

Sources of Inward Direct Investment to Belarus 2009

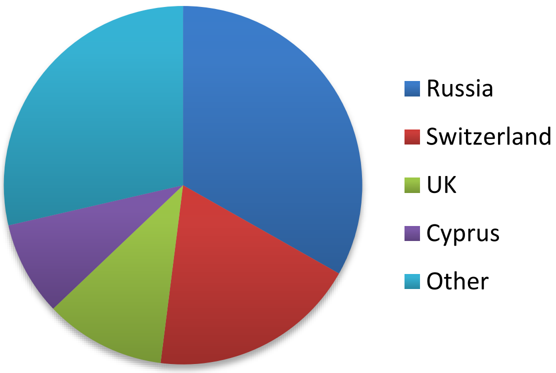
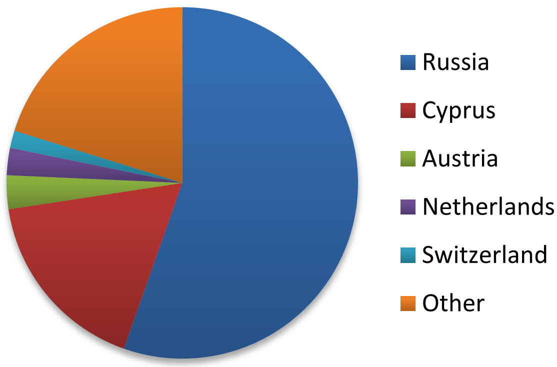


Figure 10

Sources of Inward Direct Investment to Belarus 2019



Note: Data derived from "2009 Investment Climate Statement – Belarus" by State Department, 2009 (https://2009-2017.state.gov/e/eb/rls/othr/ics/2009/117865.htm) and "2019 Investment Climate Statement – Belarus" by State Department, 2019 (https://www.state.gov/reports/2019-investment-climate-statements/belarus/)

Mechanism 1: "EU-Induced Reform"

If investors were responding to actual changes in institutional quality in Serbia and Belarus, we would expect to see Serbia improve in corruption, regulatory quality and government effectiveness. In contrast, Belarus would experience either stagnation or decline across the three indicators.

A. Corruption

In the analysed period, corruption in Belarus has decreased. As seen in Figure 3, between 2012 and 2019, Belarus has improved its Transparency International CPI score from 31 to 45 on a 100-point scale. The magnitude of the improvement is even more evident in Figure 4, which illustrates CPI Ranks. In 2009, Belarus ranked 139th out of 180 countries. In 2019, it ranked 66th out of 180.

Figure 3

Corruption Perception Index (0-100)

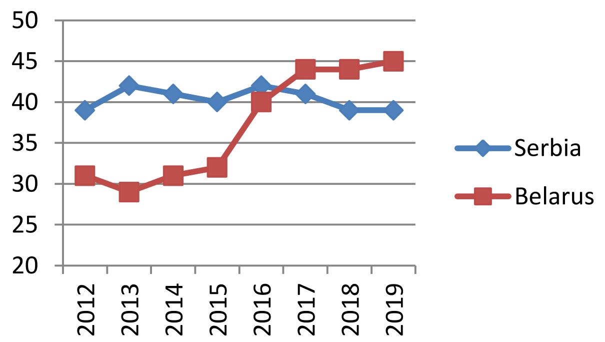
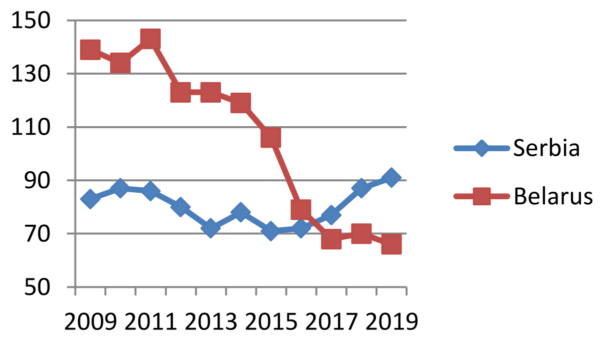


Figure 4

CPI Rank



Note: Adapted from "Corruption Perception Index" by Transparency International. For purpose of legibility, not all scores are represented on the vertical axis.

In the same period, Serbia's CPI score has been fluctuating around the score of 40. Thus, we can speak of stagnation in Serbia's fight against corruption. Looking at the global trends, Serbia fared worse in 2019 (ranked 91st out of 180) than in 2009 (ranked 83rd out of 180). The EU does not neglect this trend. EU Progress Reports list fight against corruption as one of the key challenges Serbia faces (EC, 2013), stating that corruption is widespread (EC, 2015) and that there is delay in adopting law on Anti-Corruption Agency (EC, 2018). Along the same lines, Investment Climate Statements states that "Public procurement, infrastructure projects, healthcare, education, construction and spatial planning, and public companies remain particularly vulnerable to corruption" (Department of State, 2019, p. 21). In sum, Reports published by the Commission and State Department do reflect Transparency International CPI.

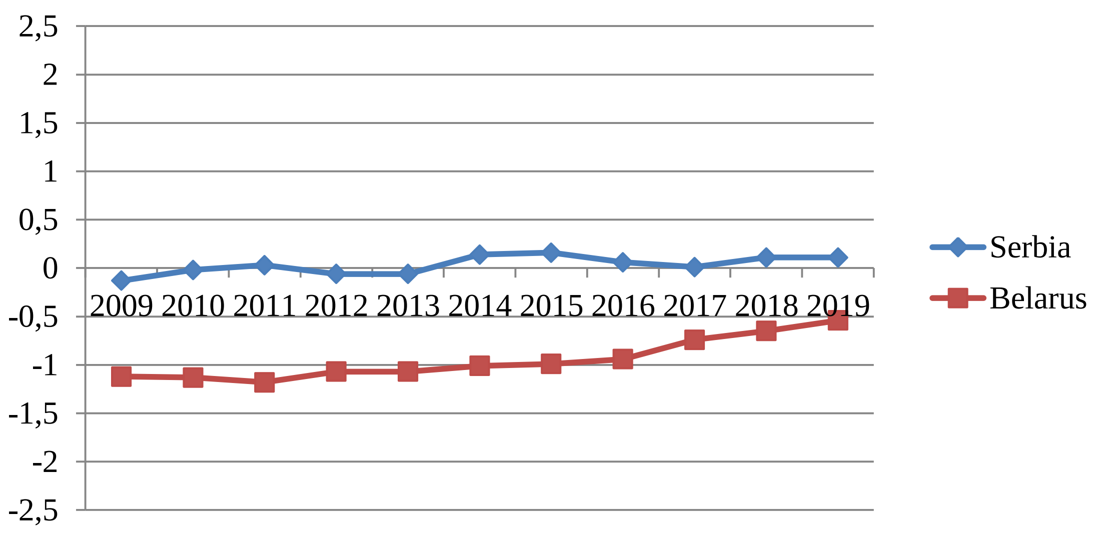
B. Regulatory Quality

Considering that both Serbia and Belarus are labelled transition economies by UNCTAD, regulatory quality is an important indicator of the openness to private sector in general, and foreign investment in particular. The regulatory quality index (RQI) ranges from -2.5 (weak) to 2.5 (strong), with the global average fluctuating between -0.01 and -0.02 in the period between 2009 and 2019. That said any improvements or declines observed below cannot be considered part of a broader global trend.

Starting with Belarus, Figure 5 clearly shows that the country was and remains far below the global average. Low regulatory quality is explained by the fact that, even after independence, Belarusian economy remained partially centrally-planned (UNCTAD, 2009). Since 2007, Belarus has undergone reforms aimed at removing the constraints on privatization and attracting FDI (UNCTAD, 2009), establishing the National Agency of Investments and Privatization (NAIP) in 2011. These changes are reflected in the data: the Index has improved from -1.12 in 2009 to -0.54 in 2019.

Figure 5

Comparison of Regulatory Quality Index: Serbia and Belarus



Note: Adapted from "World Governance Indicators" by World Bank. (https://info.worldbank.org/governance/wgi/Home/Reports).

As seen in Figure 5, Serbia's regulatory quality has slightly improved from -0.13 in 2009 to 0.11 in 2019. Here, it is interesting to compare Serbia's results from 2019 with results from some EU member states for the same year. The last country to join the EU and Serbia's neighbour, Croatia, had a regulatory quality index of 0.59. Two "problematic" EU members Bulgaria and Romania had regulatory quality indices of 0.53 and 0.46. Scores associated with the "core" members France and Germany were 1.44 and 1.72. This is to show that Serbia's regulatory quality is far from regulatory quality of the newest members of the Union, and nowhere near the EU's golden standard.

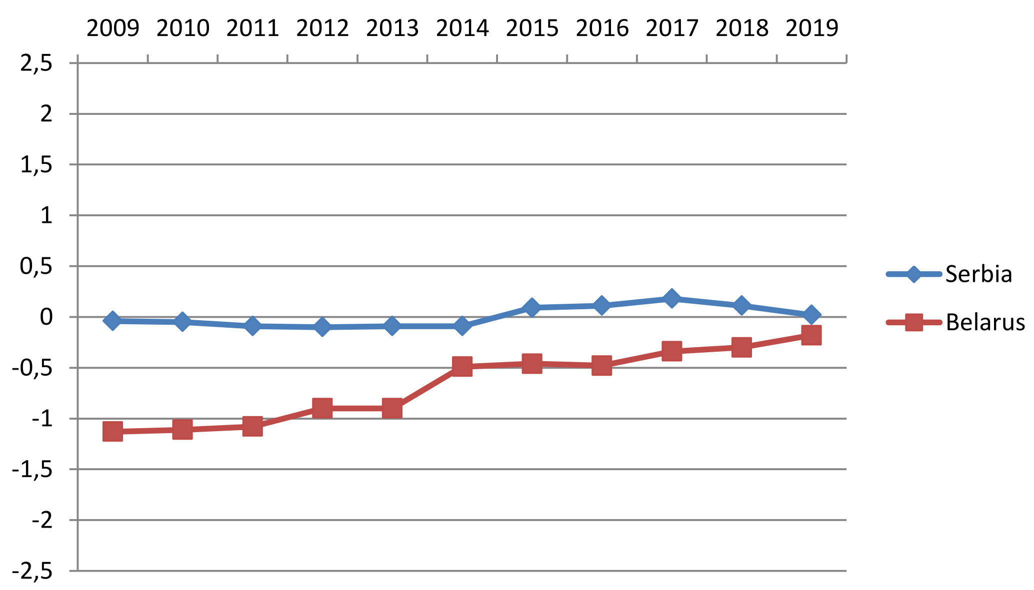
Government Effectiveness

Government Effectiveness, or the quality and independence of public and civil service, is a highly relevant indicator of institutional quality. The index ranges from -2.5 (weak) to 2.5 (strong), with the global average of -0.02 in the period between 2009 and 2019.

Observing the data for Belarus, it is evident that government effectiveness has steadily improved over the studied period. As seen in Figure 6, the score has improved from -1.13 to -0.18. Despite remarkable progress, Belarus is still well below the global average.

Figure 6

Comparison of Government Effectiveness: Serbia and Belarus



Note: Adapted from "World Governance Indicators" by World Bank. (https://info.worldbank.org/governance/wgi/Home/Reports).

Serbia's government effectiveness has slightly improved in the observed period. Its score went from -0.04 in 2009, to an all-time high of 0.18 in 2017, and down to 0.02 in 2019. On balance, it can be said that Serbia is around the global average when speaking of government effectiveness. There is still a lot of progress to be made to reach the standard of EU members in 2019, be it Croatia (0.41) or Germany (1.59).

To sum up, based on the analysis of three indicators of institutional quality (i.e. corruption, regulatory quality and government effectiveness), three preliminary findings can be presented. First, Serbia has experienced either stagnation or marginal improvements across all three dimensions of institutional quality. Second and in contrast, Belarus has improved significantly on all three indicators. Without disregarding the fact that Serbia still fares significantly better than Belarus with regards to regulatory quality and government effectiveness, it is safe to say that actual policy change alone cannot explain FDI inflows – H1 is partially disconfirmed. With that in mind, the following section turns to the analysis of the second proposed mechanism.

Mechanism 2: "Changing Perceptions"

Serbia

The following section seeks to analyze how Serbia is perceived and what expectations about its future have developed since the beginning of the EU accession process. To do so, the analysis includes documents published by the Serbian government, EU institutions and US State Department in chronological order.

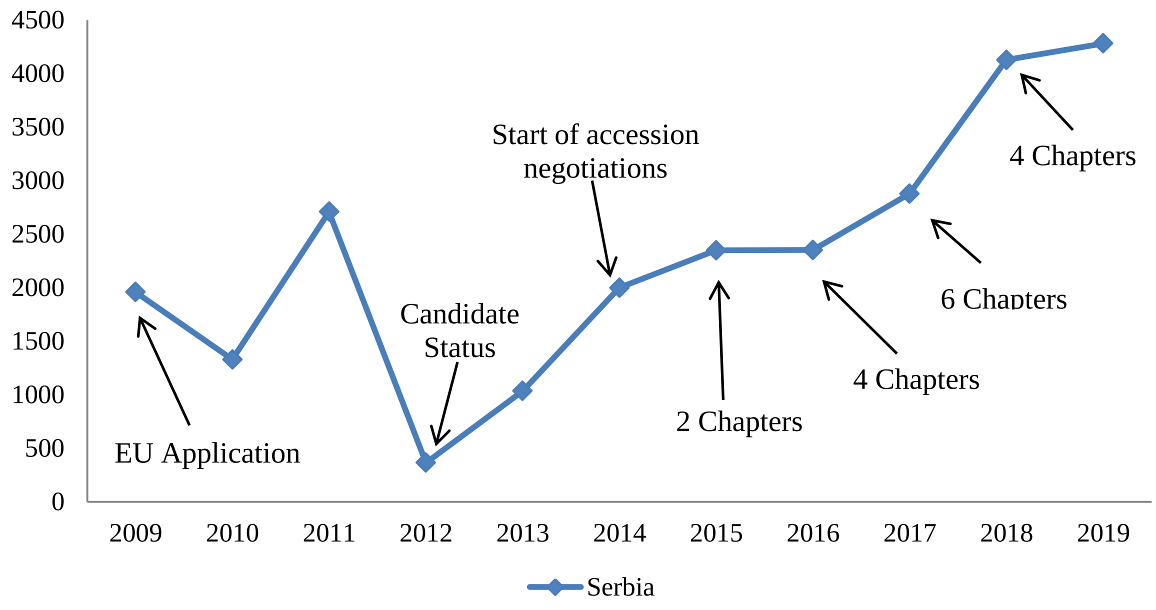
Serbia was granted the status of EU candidate state in March 2012 (EC, 2013). This step requires all EU Member States to unanimously agree. Therefore, the candidate status can be considered an important first signal. Indeed, the same year, the Investment Climate Statement claimed that "the modernization of Serbian legislation is contributing significantly to improvements in the investment climate in a variety of areas, including foreign trade, corporate governance, environmental regulation, and intellectual property rights protection" (Department of State, 2012). In September 2013, a Stabilisation and Association Agreement (SAA) signed between the EU and Serbia entered into force (EC, 2014). SAA produced an important commitment for Serbia – aligning domestic legislation with the EU acquis (Ministry of European Integration, n.d.). Under the section "What are the benefits of the SAA for Serbia?" the website of Serbian Ministry of European Integration states the following:

"Giving a clear signal to investors about the stability of the situation in the country – alignment of national legislation with EU law, conditions for investment and business are becoming recognisable and predictable to foreign investors." The first Intergovernmental Conference held in January 2014 marked the opening of Serbia's EU accession negotiations (EC, 2015). This step is also contingent on specific conditions, meaning it is a signal from the EU that the country is making progress. Commenting on this step, the US Investment Climate Statement affirmed that "these developments present a real opportunity for the country to attract new foreign direct investment (FDI), especially as the government moves to align domestic legislation with EU standards and implement other measures to improve the business environment" (Department of State, 2014; Department of State, 2015). Along the same lines, the opening of the first two negotiating chapters was anticipated to "represent an increase in political stability and present a real opportunity for the country to attract new foreign direct investment (FDI)" (Department of State, 2016). Unlocking each new Chapter, especially economic chapters, can act as a signal of progress. In addition, reporting on the ability of Serbia to take on the obligations of EU membership, Progress Reports stated that "Serbia has continued aligning its legislation to the requirements of the EU legislation in many fields" (EC, 2013, 2014). The importance of membership is also felt domestically and reflected in Reports *Why Invest in Serbia,* published by the Development Agency of Serbia. Reports present information on the estimated EU accession date on the very first page: "Serbia has continued its path toward EU membership: EU negotiation process officially started, ready for accession by 2020" (RAS, 2017). As year 2020 was approaching, the year of accession was changed: "Serbia has continued its path toward EU membership: EU negotiation process officially started, ready for accession by 2025" (RAS, 2019).

Based on this brief overview, it can be said that the positive effects of the EU candidate status on FDI were expected both domestically and internationally. While this analysis is not enough to confirm or disconfirm H2, Figure 7 allows me to draw the following conclusions. First, as already acknowledged, Serbia's FDI inflows have been increasing every year since it was granted a candidate status. Second, despite the slow pace of accession negotiations, Serbia has opened at least two chapters every year, reassuring investors of its European trajectory.

Figure 7

Serbian FDI inflows and EU Accession process



Note: Adapted from "World Investment Report 2019" by , 2019 (https://unctad.org/webflyer/world-investment-report-2019) and "European Neighbourhood Policy and Enlargement Negotiations" by European Commission, n.d. (https://ec.europa.eu/neighbourhood-enlargement/countries/detailed-country-information/serbia_en)

Belarus

Since 2009, Belarus has been part of the Eastern Partnership (EaP), a joint initiative between the EU and six partner countries: Armenia, Azerbaijan, Belarus, Georgia, the Republic of Moldova and Ukraine (EEAS, n.d.). Despite the partnership, EU documentation on Belarus is scarce. Two Strategy Papers covering most of the analysed period provide succinct and straightforward evaluation of Belarusian progress. The 2007-2013 Strategy Paper reports that "macro-economic stabilisation has improved since 2000, reforms are yet to start" (EEAS, 2007). In the same tone, the 2014-2017 Strategy Paper states that "the adoption and implementation of major bold economic and structural economic reforms remains in question" and that "Belarus' economic situation is unlikely to improve during the coming years" (EEAS, 2014).

In the same way US Investment Climate Statements comment on Serbia's trajectory based on its association with the EU, EU Strategy Paper assumes Belarus's trajectory based on its association with Russia and Kazakhstan: "considering rapprochement between Belarus, Kazakhstan and Russia within the Eurasian Single Economic Space, Belarus is likely to continue delaying the much needed structural reform, conserving strict state control over economy and other sectors" (EEAS, 2014).

On the other hand, US Investment Climate Statements on Belarus are not suggestive as Statements on Serbia. The Statement starts by stating that "Belarusian authorities stress the country's geographic location, its inclusion in the Eurasian Economic Union … as structural advantages for investment" (Department of State, 2019). The membership in the Eurasian Economic Union does not seem to generate any expectations, unlike potential membership in the EU.

Discussion and Conclusion

Discussion

In the analysed period, Serbia made no significant progress in fighting corruption and its regulatory quality and government effectiveness have remained around the global average. Despite a limited improvement in institutional quality, since 2012 Serbia has successfully attracted more inward FDI compared to the previous year. In the same period, Belarus has made significant progress in fighting corruption, improving regulatory quality and government effectiveness, yet its FDI inflows have been stagnating. Had changes in institutional quality carried significant weight in investors' decision-making process, Serbia would not experience such sharp growth in FDI inflows and Belarus would not experience stagnation. This partially disconfirms the proposition that EU-induced policy reform attracts FDI during the accession negotiation process.

After testing the rival proposition, it can be concluded that the EU accession process increases FDI to candidate states by altering the perceptions of investors about the future trajectory of that country. It was interesting to note that, in the analysed period, each US Investment Climate Statement on Serbia started by commenting on Serbia's progress in EU accession and reaffirming the importance of the process for the investment climate. On the other hand, neither EU Strategy Papers, nor US Climate Investment Statements conveyed enthusiasm for the progress in institutional quality Belarus has undeniably achieved. Instead, EU Strategy Papers present negative expectations on country's future trajectory based on its membership in the Eurasian Economic Union.

Taken together, the two cases point to a preliminary conclusion that perceptions and expectations carry more weight in investment decisions than actual reform does. The findings of this comparative study offer support for Gray's conclusion that "EU has an independent effect that is exogenous to the underlying processes that drive countries to join the EU" (2009, p. 946) and that "perceptions do not necessarily map the actual realities of a particular actor" (Gray, 2013, p. 26). In contrast, the findings go against the expectation of Bevan and Estrin (2004, p. 785) that "countries that are less successful in implementing transition policies are given longer timetables to EU accession, which may discourage FDI inflows". This thesis also indirectly addresses the effectiveness of EU conditionality. As seen from the case of Serbia, the accession process and its conditionality are no longer a guarantee of reforms.

The limitations of this research are the following. First, having compared similar systems, conclusions can be applied in a restricted space and time (Porta, 2008, p. 214). In the same way that findings on the Eastern Enlargement do not hold in the present (Bevan & Estrin, 2004), one should not generalize the findings of this study to other rounds of enlargements. Second, the analysis pays limited attention to the role of the Eurasian Economic Union. Thus, the study does not capture potential negative effects of Belarus's membership in this Union.

On that note, further research should examine the effect of EU candidate status on FDI inflow to other candidate states, namely Albania, Montenegro and North Macedonia. This would allow drawing generalizable conclusions on the effect in question. Second avenue for research that would be both academically and policy relevant is research into the effects of membership in international institutions with "bad reputation", such as the Eurasian Economic Union.

Conclusion

This thesis has investigated the effect of EU candidate status on FDI inflows. In doing so, it has first addressed the lack of literature on the economic effects of the current round of EU enlargement which differs in its length and methodology from previous, well researched rounds. Second, it has addressed a disagreement in the literature on the mechanism behind the effect. In answer to the research question, it can be concluded that EU candidate status has a positive effect on FDI inflows. The mechanism behind the effect is the altering of perceptions and expectations about the future trajectory of a candidate country.

The practical implications of this thesis are the following. First, given that the psychological effect of being associated with certain countries is not negligible, transition countries should pay attention to "the company they keep". Specifically, Serbia should pay close attention to how its recent rapprochement with China is perceived in the EU. Second, EU candidate states should use the findings to their advantage. Emphasizing the prospect of EU membership by national investment agencies might be instrumental in shaping investor perceptions of Albania, Montenegro and North Macedonia. Third, foreign investors should reconsider the credibility of the EU accession process. Also, MNCs should re-evaluate the power of membership and the prospect of membership in international organization to keep states committed to certain policies.

Appendix 1

Opening of Negotiating Chapters

Date	Chapter Opened
10-12-2019	Chapter 4 - Free movement of capital
27-06-2019	Chapter 9 - Financial services
10-12-2018	Chapter 17 - Economic and monetary policy
	Chapter 18 - Statistics
25-06-2018	Chapter 13 - Fisheries
	Chapter 33 - Financial and budgetary provisions
11-12-2017	Chapter 6 - Company law
	Chapter 30 - External relations
20-06-2017	Chapter 7 - Intellectual property law
	Chapter 29 - Customs Union
27-02-2017	Chapter 20 - Enterprise and industrial policy
	Chapter 26 - Education and culture (provisionally closed)
13-12-2016	Chapter 5 - Public procurement
	Chapter 25 - Science and Research (provisionally closed)
18-07-2016	Chapter 23 - Judiciary and fundamental rights
	Chapter 24 - Justice, freedom and security
14-12-2015	Chapters 32 - Financial control
	Chapter 35 - other issues
	Item 1: Normalisation of relations between Serbia and Kosovo*"

Note: Adapted from "European Neighbourhood Policy And Enlargement Negotiations" by European Commission, n.d. (https://ec.europa.eu/neighbourhood-enlargement/countries/detailed-country-information/serbia_en)

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