Low Labor Cost as a Determinant of Foreign Direct Investments in Albania, Kosovo and North Macedonia

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Abstract: Expanding activities abroad to exploit existing advantages, to seek economies of scale or to finalize a production phase in an economy other than that of the home country is common for multinational enterprises (MNE), whilst seeking new locations where higher intensity of labor is required is a characteristic especially for the vertical foreign direct investment (FDI) and export-oriented firms. Low labor cost is considered one of the primary comparative advantages for the countries of South-Eastern Europe in terms of attracting FDI. Our paper contributes to the literature by examining how low labor cost impacts the level of FDI inflows in three countries of Western Balkans: Kosovo, Albania and North Macedonia. Our analysis reveals that low labor cost is not positively related and significant in these countries with regard to the attraction of FDI inflows.

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Introduction

In both developing and advanced countries, FDI has become a standard part of the economic policy. The FDI is expected to contribute to economic development in developing countries by bridging the gap between domestic savings and investment needs. This contributes to economic growth through increased production potential and job creation. Hence, in pursuit of welfare and growth, countries oriented policies on attracting FDI by becoming more accessible and developing inciting policies aiming to absorb technology, cutting-edge devices, managerial skills and boost efficiency (Enderwick, 2005: 95; Asongu, et al., 2018: 2). Historical data shows that developed countries attract the highest inflows of FDI, 50.68% in the period 2010-2019, being, in the meantime, the main outsourcing countries as well. However, the landscape is shifting in recent years, as it becomes normal for developing countries to engulf the biggest part of FDI inflows (World Bank, 2019). The positive attitude towards FDI incited various governments' policies to foster the growth of inflows in respective countries. Implementing the right policies is particularly important for transitional and developing economies which commonly face a lack of financial resources from abroad. Being the main source of foreign capital, FDI flew toward South-East Europe in the beginning of the 1990s. The region consolidated its political position in recent decades establishing a peaceful environment, applying macroeconomic reforms and, designing suitable policies for the attraction of foreign investments. The completion of the integration into the EU fostered FDI inflows for some of the countries of South-East Europe (Carstensen &Toubal, 2003: 16; Sakali, 2014: 74). Western Balkans, which according to the European Commission refers to Albania, Bosnia & Herzegovina, Kosovo, Serbia, North Macedonia and Montenegro, lagged behind the rest of the continent in terms of attracting FDI. In

Donjetë E. Rexha
Low Labor Cost as a Determinant of Foreign
Direct Investments in Albania, Kosovo and North Macedonia

105

the last three decades, the Balkans experienced civil wars, the emergence of new countries and the dissolution of central planned economies. The shadow of a long troubled history of ethnic conflicts still bears the image of the region failing to fade the doubts and insecurity of potential investors (Estrin & Uvalic, 2014: 283). However, the region scored immense changes since the 2000s, witnessing a challenging transitional process, both economic and political. The beginning of a peaceful era, economic reforms and cooperation with the EU widened the horizon of positive changes. The increasing number of companies setting up their operations in the region is evidence of economic liberalization and increased economic growth. As the absorption of FDI inflows initially emerged in the midst of the 1990s, the average growth rate for the period 2009-2019 was 17.86% (World Bank, 2019).

Figure 1: FDI Inflows in Albania, Kosovo and North Macedonia
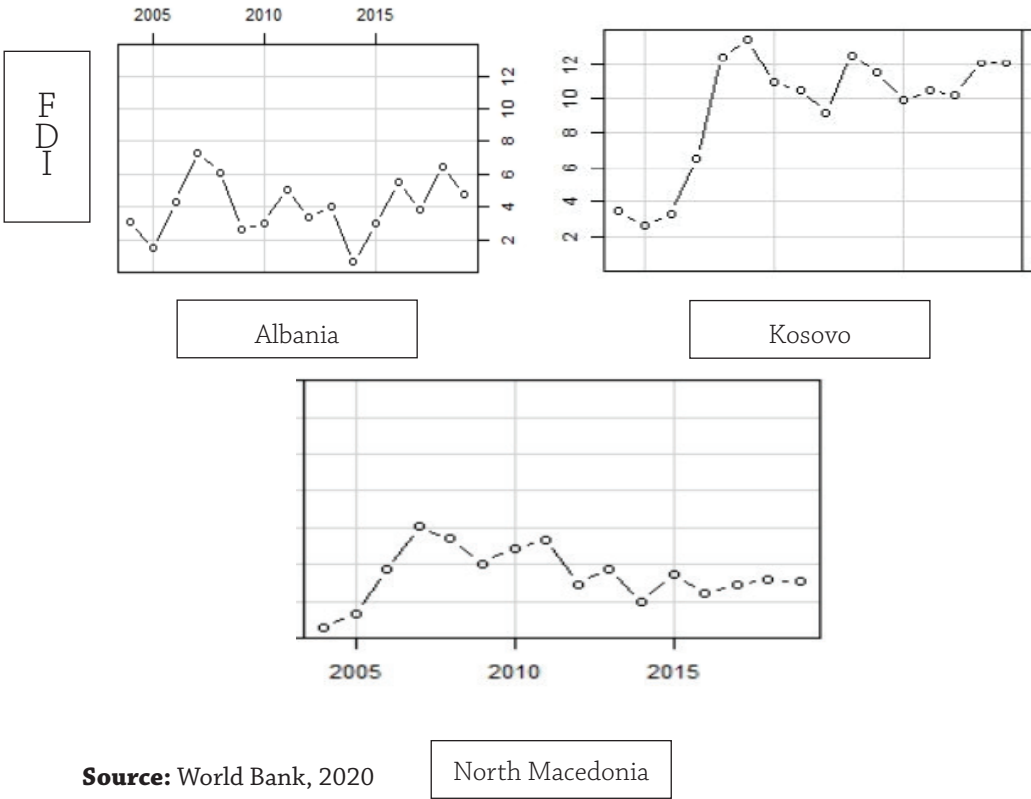
Source: World Bank, 2020

Figure 2: Trend of FDI Inflows in Albania, Kosovo and North Macedonia
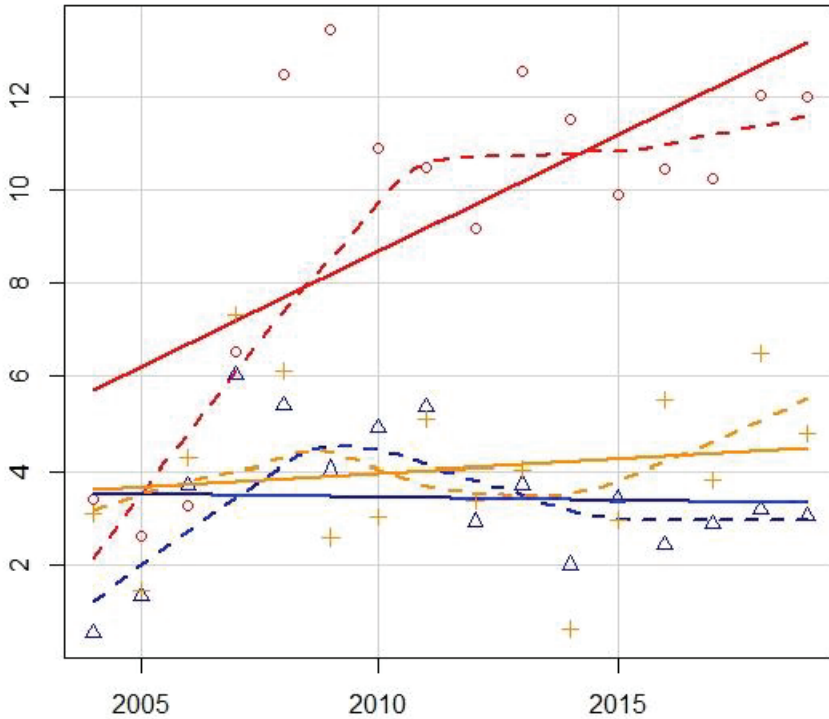
●   Albania;   △ Kosovo;   + North Macedonia
Source: World Bank, 2020

The move forward by the countries of the Western Balkans region marked a period of positive changes which were associated with the transitional process to the free market economy and deep reforms implemented by respective governments. This contributed to a robust growth rate of around 3% and a stable macroeconomic environment, whilst links with the EU added additional competitive advantages in terms of absorbing foreign investments. For a region that lacks developed financial markets, FDI remains one of the most important sources of capital. Hence, attracting FDI is one of the main pillars of economic growth and job creation. A positive and growing trend accompanied the level of FDI inflows in the countries. Albania makes the largest recipient country with an average of annual FDI inflows of $943mln in the period 2004-

Donjetë E. Rexha
Low Labor Cost as a Determinant of Foreign
Direct Investments in Albania, Kosovo and North Macedonia

107

2019. Two other countries, Kosovo and North Macedonia remain far below in terms of attracting investments, with an annual average of $343mln and $403mln for the same time periods. The energy and mining sector was most appealing to investors in Kosovo and Albania whilst the real estate, banking and insurance sector appear to be preferred in all markets. In terms of FDI origins, the flows stem mainly from the EU and neighbor countries (IETL, 2019: 36). A growing volume of research papers explain the economic implications of FDI for the host and investing country. Considering the obstacles of operating in an often distant market, unfamiliar culture and high asymmetric information, only the most productive firms can bear the risks and challenges of managing multiple subsidiaries abroad. FDI consists of capital flows of firms with specific asset advantages such as: technology, managerial skills and trademarks. Multinational firms happen to overpass obstacles of incomplete contracting problems when they sell or license these assets directly and to keep assets within the firm avoiding the risk of holdup by competitors (Pandya, 2010: 392). There are many theories about the main determinants of FDI inflows. While FDI is an important source of capital for developing and transitioning countries and there is a general perception that they bring positive effects to the country, there is a lot of research on what drives foreign companies to invest abroad. Research on the relationship between labor costs and FDI inflows in the Western Balkans economies is scarce. As far as we know, there is a lack of evidence to sum up how far labor costs lead flows of direct investments into the region. This study aspires to contribute to the debate on this matter. This paper will explore whether labor cost and foreign direct investment in three Western Balkans countries: Albania, Kosovo and North Macedonia have a positive relationship with each other. Following the introduction, the structure of this paper includes a total of three sections starting with a review of the literature on foreign investment theories. The second part includes a special section on elaborating the importance of labor cost for potential foreign investors. The third part includes the introduction of the study methodology, data collection and hypothesis. This final part also presents the results of the research and a discussion thereof. At the end there is a conclusion with the summary of the results.

Literature about the Determinants of Foreign Direct Investments

Globally, developing countries are promoting various policies to attract multinationals

to invest. Multinationals frequently enjoy a wide range of policies which include tax benefits and supportive economic regulations (Lashitew & Wall, 2018: 1). Throughout history, depending on national and ideological circumstances, countries have often tended to perceive FDI as a threat to their resources or state sovereignty. Even today, there are certain national security sectors where foreign investment is restricted or not allowed at all. It was only the 1980s when the movement of capital between countries became more visible and more significant in terms of importance and consequence that studies on this topic became more intensified. Hymer was one of the first to contribute to FDI in his dissertation topic, emphasizing that firms are motivated to move capital abroad to take control of new markets and increase profits. Firms are also looking to exploit their advantages and seek to take advantage of these advantages in markets other than the local market (Hymer, 1960: 25). Many theories have been constructed about FDI determinants with none of them dominating the other. But what is most mentioned in the literature and incorporates more elements into the study of FDI influencers is Dunning's "eclectic paradigm." The theory is attributed to three dimensions: ownership, which refers to the specific assets of the investment firm; location, which refers to the characteristics of specific markets that influence the chances of expanding activities there; and internalization, which refers to the value of retaining the advantages of ownership within the firm and entering the country, instead of exporting them to another country (Wilson & Baack, 2012: 97; Stoian & Filippaios, 2008:3). The eclectic paradigm of Dunning which provides the most decisive reasons on the motives of MNE to invest in other markets rather than the domestic market also provides a theoretical explanation about the types of FDI. Four are the types of MNE investing in a foreign market:

    a.   MNE that target the local market and aim to use their competitive advantages to fulfill the needs of solely local consumers. Therefore, their focus commonly is: market size, domestic market structure and consumer preferences. The size of the market is measured through the population number and macroeconomic indicators, such as growth rate, level of GDP and income per capita. These kinds of investors are known as market-seeking investors.

    b.   Resource-seeking FDI is another category of investors that make the decision to invest in a particular market based on the country`s resource capacities. Resources include: natural resources, raw materials, low labor cost, abundant work force, and infrastructure quality.

    c.   Efficiency seeking FDI involves investment firms that are seeking markets

Donjetë E. Rexha
Low Labor Cost as a Determinant of Foreign
Direct Investments in Albania, Kosovo and North Macedonia

109

with lower production costs and other advantages that would enable those firms to successfully compete in the international arena. These kinds of investments appear to be harder to attract: lower costs, efficiency of human capital, technology and infrastructure requirements. Being more than just a source of capital, efficiency seekers contribute to the creation of new jobs in a wider range of sectors in the economy, adding additional values to the host country.

d.   Lastly, strategic asset seeking FDI is motivated by investor`s goal to acquire new assets abroad that would add value and comparative advantages to the existing portfolio. Typically, these investments take the form of mergers & acquisitions and tend to lift up their competitiveness capabilities and reduce that of competitors by acquiring protection in the market, benefiting from trademarks, distribution channels and manpower (Franco et al., 2008: 5; Wadhwa & Reddy, 2011: 220).

e.   Dunning provides a taxonomy of micro and macro determinants that helps to explain the firm's ability and desire to carry FDI. Designed to account for the costs of running abroad, a firm should first identify some of its distinct features that would overcome the disadvantages of operating in a foreign market (Carstensen &Toubal, 2003). Other theories explain the determinants of FDI inflows by considering various economic and non-economic aspects (Dung et al., 2018: 4). Market size, natural resources, labor costs, inflation and return on investment are generally considered as economic determinants for attracting FDI inflows (Dung, et al., 2018: 4; Esiyok &Ugur, 2017: 462; Shah, 2016: 3). Market size which is mainly measured by the level of GDP, GDP per capita or population number is considered to have a positive impact on attracting foreign investments as it is associated with higher market demand and business opportunities (Ranjan & Agrawal, 2011: 257; Randelovic et al., 2017: 98). The enhanced attention of investors only in some industries, might deprive the host country of spillover effects, and this might be an adverse effect of natural resources which otherwise are considered to have a significant influence in terms of attracting foreign investors (Asiedu, 2013:3; Arshad, 2017: 5). Inflation movements as a macroeconomic indicator are closely monitored by investors as the inflation rate directly affects the profit of business activities. Too high or too low rates can erode profits, increase uncertainty and increase the cost of capital. For this reason, a stable rate is taken as an indicator of the healthy economy of the host country (Sayek, 2009: 420; Alshamsi et al., 2015: 139; M.Mustafa, 2019: 51). Return on investment is one of the main reasons for the decision to expand business activities. The flow of investment in the host country depends on the rate of return on investment and the certainty or uncertainty surrounding that return. The decision-making process to determine the location of the investment is complex and in most cases involves a wide range of factors. Therefore, in countries that are perceived to have a lower degree of security, investors tend to seek projects with higher rates of return to offset the risk undertaken and thus also limit project opportunities (Ahamed & Tanin, 2010: 15). Although higher labor costs tend to increase FDI outflows and decre-

ase FDI inflows, that might not be the case always. Labor costs may not, though, impede FDI inflows if both legal and economic environments are high market potentials in the host country. Actually, the labor quality is of higher importance for investments occurring in developed countries (Lai & Sarkar, 2011: 397).

Low Labor Cost and FDI Inflows

The growing role of foreign investment in the global economy has increased research and discussion on the factors influencing their attraction. In recent years, mobility of international capital has significantly improved. In the global labor division, the growth of FDI inflows has surpassed foreign trade and national production, and multinationals play an ever-increasing part. (Eckel, 2003: 20).Therefore, part of the literature focuses on analyzing the impact of labor costs on attracting investment. So is labor cost an important factor for FDI inflows? First, we need to explain what is meant by the cost of labor for which the terms are commonly used: "labor costs" and "wages". If we analyze these two terms we see that they are not the same thing, with the first including: wages plus taxes and benefits determined by policy makers of the host country. The term "wages" is defined as the direct contribution paid for employers' productivity. In the perspective of the job suppliers (firms), overall labor cost is the important index, but labor suppliers are primarily concerned about the salary/compensation aspect of the overall cost (Saglam & Boke, 2017: 2). Regarding the significance of low labor cost as a determinant of FDI inflows level, the results are ambiguous. Economic theory implies that holding all other factors constant, a higher cost of labor discourages potential investors by diminishing the other advantages the host country could offer. Cheap labor force can provide competitive advantages to countries possessing this kind of resource. Hence, regions with abundant cheap labor resources are prone to attract higher levels of FDI inflows (Lashitew & Wall, 2018: 10). Commonly, export-oriented firms and labor intensive sectors consider low labor costs as a factor of significant importance in the process of decision-making to invest abroad. Therefore, during the early stages of economic development, countries are prone to attract such FDIs implying a positive relationship between low labor costs and FDI inflows (Donaobauer & Dreger, 2016: 12). Firms that distinct their production processes into several stages (vertical FDI), seek low labor cost countries to execute those stages of higher level of labor intensity. Firms exploiting their existing advantages by expanding activities abroad seek to benefit from economies of scale, therefore low labor costs are of significant importance

Donjetë E. Rexha
Low Labor Cost as a Determinant of Foreign
Direct Investments in Albania, Kosovo and North Macedonia

111

(Masso et al., 2007: 8). Further stages of development which are commonly associated with increased wages and society welfare tend to affect FDI negatively. Along with its relatively smaller magnitude as compared to the size and distance of the host country, the effects on FDI inflows are statically important. Therefore, prospective government policies should be used to significantly enhance labor productivity in order to offset for the soaring salary costs (Bellak et al., 2007: 33).

Labor Market in Kosovo, Albania and North Macedonia

For emerging and new market economies of South East Europe, the most critical competitive advantage is that of low labor costs. However, the evidences are limited about the extent to which labor costs drive FDI inflows to these economies. Labor costs are relatively low in the region compared to the rest of the continent. The region`s job markets are characterized by significantly high levels of informal economy and persistent long-term unemployment (World Bank Group & Vienna Institute for International Economic Studies, 2019: 13). In these economies, using this cheaper labor is thus a key necessity. But, why this steady unemployment rate occurs? After the financial crisis of 2009, Western Balkans experienced an increased economic development which was followed up by a steady growth of employment too. Nevertheless, the structural problems and shortcomings like skill mismatches, weak entrepreneurship abilities and access to productive inputs as well, make a growth rate of 4% insufficient to fill the demands for labor (World Bank Group & Vienna Institute for International Economic Studies, 2019: 31). Hence, the cheap labor cost is an advantage stemming from disadvantages of the economic environment characterized mainly by private consumption and capital investments by governments. A negative trade balance and the lack of investment in sustainable employment sectors lead to fragile development which should be turned into growth and prosperity in the future (World Bank, 2019: 1-10). The unemployment rate of the region remains the highest in Europe, with an average of 21.49% during 2019-2020 and Kosovo at elevated levels in a rate of 29.88% (CEIC, 2019). The youth and women are particularly hit from unemployment and in the long-term. The governments are continuing to develop and explore different policies in the host countries to attract foreign investors, while companies around the world are shifting their ways of competitiveness. Even though the region seems to be on the right path of sustainable economic growth, FDI inflows remain to reach the much desired level. Skilled labor

force, higher quality of education and greater government incentives should be translated into increasingly attractive bundles for potential investors (Bruno et al., 2006: 3; Becker et al., 2020: 124).

Methodology

Our goal is to explore whether low labor cost drives foreign direct investment inflows. Considering the theoretical overview of FDI determinants and the characteristics of the region, our hypothesis implies that there is a positive relationship between FDI inflows and low labor cost for the countries of Western Balkans: Kosovo, Albania and North Macedonia.

Ho: There is a positive relationship between FDI inflows and Low Labor Cost in Kosovo, Albania and North Macedonia.

For the purpose of our research we have gathered data from the World Bank Dataset regarding the annual inflows of FDI for the countries included in the sample. The time series includes the period among 2004-2019. The average annual labor cost was estimated considering the monthly income for the same time series as for FDI inflows. Linear Regression Model was used for the data analysis.

Model Explanation

The Linear Regression Model is used to calculate the association of two or more variables. It is an approach in which a dependent variable on one or more separate variables is predicted. The notion of linear regression was first introduced by Sir Francis Galton in 1894, being the most commonly used method of statistical analysis. A distinctive feature of linear regression is that the influence of other characteristics that may affect the dependent and independent variable is taken into account (Kumari & Yadav, 2018: 33).

The econometric formula of the Linear Regression Model is as follows:

$$Y = \alpha + \beta_1 X_{1} + e$$

Where:

- Y – is the dependent variable;

Donjetë E. Rexha
Low Labor Cost as a Determinant of Foreign
Direct Investments in Albania, Kosovo and North Macedonia

113

• α – is the constant (intercept) of the regression model;

• β1 - is the coefficient of the independent variable;

• X1 – is the input value or predictor variables;

• e – the error of the equation;

The dependent variable denoted by Y in the regression equation is the variable the model aims to explain. The α which is known as the constant of the regression model indicates the value of the dependent variable in case the value of independent variables is zero. The independent variable, denoted by X in the equation is the factor we assume has an impact in the dependent variable. The strength of the effect of each individual independent variable to the dependent variable is shown by the beta coefficient. Namely, a positive/negative coefficient determines the direction of the line`s slope showing an increasing impact in one variable once the other (negative coefficient) is increased and vice versa. The "e" being the last element of the equation marks the error that is not explained by the regression line (Sarstedt & Mooi, 2014: 211-212).

Assumptions of the Linear Regression Model

In addition to the model formulating, fitting the model to data, the statistical modeling process also includes the process of checking the model. The checking process might lead to further analysis of the data or to an entire cycle of reformulation. Hence, in order for the regression model to provide valid results there are a few assumptions that should be met and which are presented below:

• Linearity – the relationship between the independent variable x and dependent variable y is linear.

Figure 3: Linearity Test
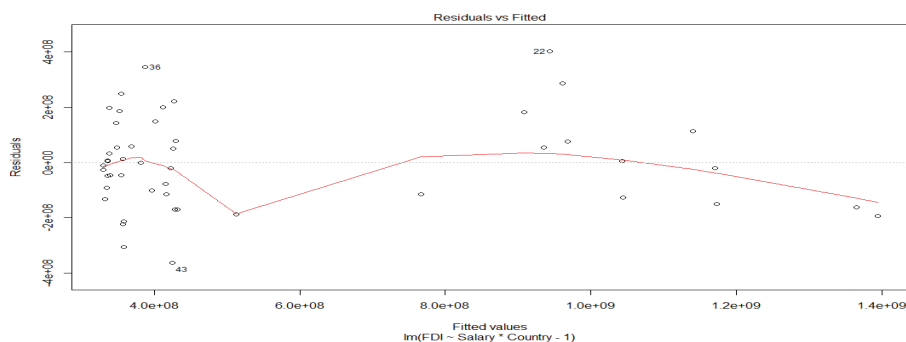
Source: Author`s Data

Checking the linearity between X and Y variables can be done by plotting the inde-
pendent variables against the dependent variable. The linear pattern can be assessed
using a scatter plot and in our case the almost horizontal red line shows the fulfill-
ment of the assumption.

• Homoscedasticity refers to a condition in which the variance of the residual, or error
term, in a regression model is constant. That is, the error term does not vary much as
the value of the predictor variable changes.
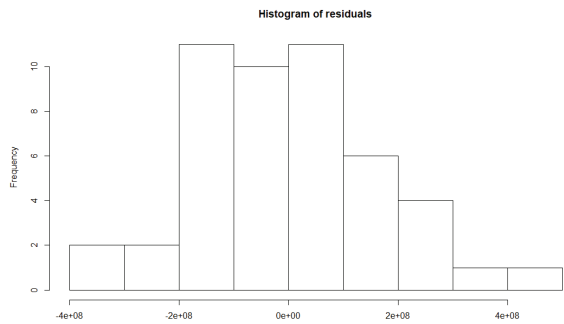
Figure 4: Homoscedasticity Test
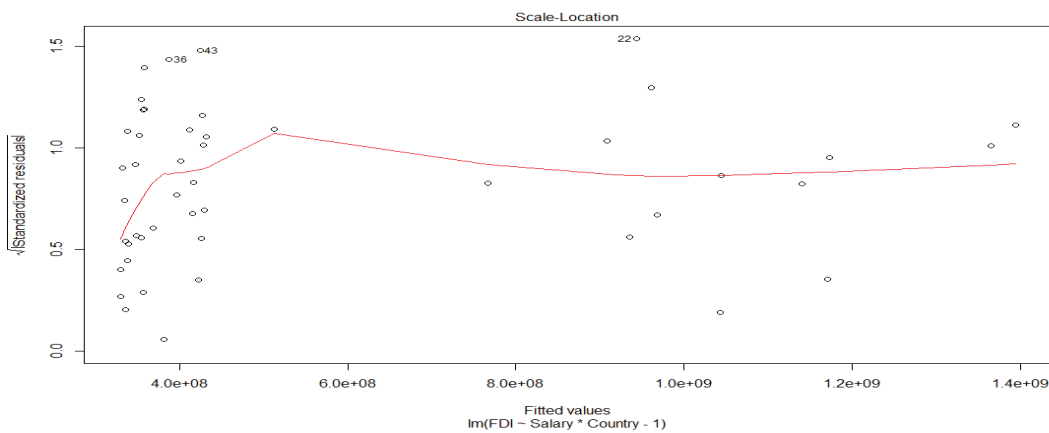
Source: Author`s Data

Checking the homoscedasticity in our regression model, we plot errors against the de-
pendent variable Y. Using a scatter plot, the red line in an almost horizontal shape con-
firms that the assumption for our data is met.

• Error distribution –the assumption is that the regression model errors are approxima-
tely normally distributed.

Figure 5: Normality Test of Residuals

Source: Author`s Data

Donjetë E. Rexha
Low Labor Cost as a Determinant of Foreign
Direct Investments in Albania, Kosovo and North Macedonia

115

Fig 5 shows the normality test of residuals which marks errors in each data point. The histogram of errors shows that a normal curve can be plotted, indicating that the errors are normaly distributed, thus fulfilling the assumption of the regression model.

Data Analysis

Table 1: Linear Regression Model – Results

Dependent Variable:	FDI			
Method:	Least Squared			
No of Observations:	48			
Variable	Coefficient	Std. Error	t-statistic	p-value
Salary	3148473	467491	6.735	0.000
Albania	-413419966	206200585	-2.005	0.051
Kosovo	376529169	152604317	2.467	0.018
North Macedonia	239645245	291006331	0.824	0.415
Salary: Kosovo	-3229414	586496	-5.506	0.000
Salary: North Macedonia	-2874630	671455	-4.281	0.000
Residual Standard Error	175400000			
Df	6, 42			
Multiple R Squared	0.9397			
Adjusted R Squared	0.9311			
F – Statistic	109.1			
Df	6 and 42			
p-value	0.000			

The linear regression model was implemented for the analysis of our data taking into account the heterogeneity across countries and years. The resulting variable is that FDI and wage is the only predictor. The regression output indicates that 93.97% of variation in annual FDI inflows is explained by the average labor cost per year. And only 6.03% of the variation is caused by factors other than labor cost. The model has a sufficiently high coefficient of determination, indicating a fairly high predictive quality of the resulting model. Hence, the F-statistic and indicates an established relationship between the labor cost and FDI inflows only by controlling country. Besides the fact that this relationship (under the control of country) exists, it does not mean that his relations-

hip is casual.

Hence, our regression equations are as follows:

Albania:

$$Y = -413419966 + 3148473 * Salary$$

In the case of Albania, the positive sign of slope coefficient in the regression equation and a p-value <0.05 implies the positive relationship of labor cost and FDI inflows.

Kosovo:

$$Y = 376529169 + (-3229414 + 3148473) * Salary = 37652916 - 80941 * Salary$$

In the case of Kosovo, the negative sign of the coefficient in the regression equation and a p-value < 0.05 implies a significant relationship between labor cost and FDI inflows, intending that a reduction of labor costs may increase FDI inflows in the country, but this requires additional research, since in neighboring Albania it is the other way around.

North Macedonia:

$$Y = 239645245 + (-2874630 + 3148473) * Salary = 239645245 + 273843 * Salary$$

As in Albania, in North Macedonia, the positive sign of the coefficient in the regression equation and a p-value <0.05 implies a significant positive relationship between labor cost and FDI inflows.

Based on the elaboration of the analyses above, the results imply the rejection of the hypothesis raised in this paper that low labor cost has a positive and significant impact on the level of FDI inflows in Kosovo, Albania and North Macedonia. The model shows that the cheap labor cost is of significant importance for attracting FDI inflows in Kosovo. In Albania and North Macedonia an increase in labor cost increases FDI inflows, and vice versa. Namely, the flows of investments are more significantly influenced by other factors explored in the theory of FDI.

Conclusion

This paper provides new evidence on the relationship between FDI inflows and low labor cost in Kosovo, Albania and North Macedonia. The linear regression model using

Donjetë E. Rexha
Low Labor Cost as a Determinant of Foreign
Direct Investments in Albania, Kosovo and North Macedonia

117

time series data shows a positive and significant relationship between low labor cost and FDI inflows for Kosovo while the relationship is negative for Albania and North Macedonia. However, the literature overview shows that the importance of low labor cost is more significant in terms of attracting foreign investors especially for those countries which might lack other important determinants of FDI inflows such as market size. Hence, extracting maximal benefits from the abundant workforce is vital. Even though our findings suggest a rejection of our hypothesis, the importance of low labor cost should not be undermined in the region. Still remaining at the bottom of European countries in terms of labor cost, these countries should make continuous en-deavors to attract investors whose primary motive to invest abroad is cheap labor cost.

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Donjetë E. Rexha
Low Labor Cost as a Determinant of Foreign
Direct Investments in Albania, Kosovo and North Macedonia

119

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