

# Innovation, Foreign Direct Investment And Challenges For Government Reform

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**ABSTRACT** Multi-national Corporations (MNC) are being playing a major role on research and development, not only through activities in their home country but also in host countries through investments. The globalization of R&D is not a new phenomena, the novel element lays in the accelerated steps these last year. However the geographic disperse of R&D, realized through their branches, is not homogenous and only a few economic communities have taken the major part. It is obvious that the abilities host economies posses to attract FDI's are subject to political, economical legal national culture and off course to physical and human infrastructure in line with economical objectives and economic national economies. An ever growing number of countries have developed a positive stance toward FDI's that bears R&D, considering this a way to scale up their competitiveness. The total flux of FDI in Albania is significantly risen, from 258 mil \$ in 2006 in 705 mil\$ in 2009 në 1.190 bill. \$ in 2011. The foreign direct investments have been in positive trends despite the global and regional financial and economical crisis, evidently reflecting a continuing rise through 2012. (Report of Foreign Investments 2011). However, the Republic of Albania scores in the 25<sup>th</sup> position, this number can be advance to 20. This article aims at establishing a framework for the exploration of the obstacles to attract R&D relating FDI's and present the reasons for this moderate success on behalf of Albania. First off, the factors that impacts globalization are presented, followed by major reasons why a certain country has been chosen. The main obstacles on attracting these investment are been analyzed. Finally the findings are presented.

**Keywords:** Foreign Direct Investments, research and development, transition economies

## 1. INTRODUCTION

Foreign Direct Investment is an integral part of an open economical system and a major katalisator of economic development. However, the benefits of FDI do not happen automatically and not disperse evenly among communities. National politics and the international structure of investment do matter for the attraction of FDI's into an ever growing number of developing countries and for a better absorption of the positive potential of those investments into sustainable growth. Challenges mainly are on the side of host countries, which have to create an open, transparent environment, that is clear and effective politics for the attraction of such investments and to build human and instructional infrastructure for the proper implementation of such politics. The role FDI's plays for guiding economic development and economic growth has ever been a contested one. Since the beginning there have been viewpoints in favor and against FDI. Some authors, argues that FDI led to economic growth and increase of productivity and hence to economic development, but others note the risk of FDI in destroying local capacities or over- exploiting the natural resources. There has been an increase of FDI into developing countries noted recently, although concentrated in certain countries, reflecting economic wealth and barriers to trade. However, the decision making factors of FDI and as a consequence also the perspective of development dictated by FDI have changed over the time.

As the barriers to trade and investment do have an impact to attracting FDI's, the later are in the search for countries in the web of global production processes, hence in need for countries with good economic foundations such as: size of the market, adequate human resources, decent infrastructure and good technological local capacities. Nonetheless, as countries have begun to understand the positive effect of FDI's, a diverse perception about the role of FDI on sustainable development has risen among the academic community, perceiving the impact of FDI not only positive or negative, but the effect varies on typology of FDI's, firm characteristics, economic conditions and host countries politics. The type and sequence of general and specific policies in areas that covers investment, trade, innovation and human resources are considered as crucial within the link FDI and development. As FDI are superior in terms of capital and technology, the spillover effect into the development does not happen automatically. The suitable politics for attracting FDI's include: a) building human resources, b) building infrastructure and technological capacities, c) increase the absorption capacities to catch the spillover effect created by the productivity potential of FDI's. Countries have always used general and specific policies to reach the point where FDI's work for development. As a conclusion, one can note that a major change has happened in FDI's liberalization and nowadays FDI's are considered as more positive than a couple decades ago, while governments steadily perceives that their politics can influence the FDI's effects on economic development.

## 2. Analysis

Foreign Direct Investments are an integral part of an open economic system and a major katalyzator for development. However, the possitive potential of FDI does not happen automatically and evenly dispersed across the local communities. National politics and global architecture of investments does matter for FDI attraction in an ever growing number of developing countries and for the obsolete absorption of the possitive potential of such investments in sustainable development. Challenges are mainly on developing countries behalf, wich must

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establishes an transparent environment, that is clear and effective politics for FDI attraction and to build human and institutional capacities for implementing such politics. The role of investments, mainly of foreign direct investments (FDI), in economic development and economic growth has been contested ever since. There have been always opinions in favor and against the FDI. Some argue that FDI lead to economic growth and raise of productivity as a whole and hence to economic growth and sustainable development, but others note the risk of destroying local capacities or over-exploitation of natural resources without adequate compensation for poor countries (Amartya Sen, 2009). A significant indicator- even though not complete- for economic growth from FDI, is the level of FDI. Doubtless, 1) FDI level and 2) relative importance of FDI in national economies have changed over the years and across the markets. Both these indicators were high in the first part of the century, slowback in middle and again high in our days. A major change during these three last decades is the fact that gradually governments have become more friendly vis a vis FDI, nonetheless in different times and depths. During these last 15 years, countries consider FDI as a contributing factor to their development strategies for their financial and technological capital. Governments even compete in a FDI regatta. Investments policies have become more liberal in national and regional level; however there is no regulative framework for multilateral level. Independently, while countries have become to understand the positive effect of FDI, a different perception regarding FDI and sustainable economic development is emerging in the research community, seeing the FDI impact in economic growth not only as positive or negative (the FDI quantity is not enough for growth projections), but effect depends on FDI typology, firm characteristics, economic conditions and host country politics. For example, typology and motive of FDI has proven to be instrumental for transforming the productive market structure in East Asia countries, while the same does not stand for natural resources FDI in poorly governed but rich in oil countries (i.e. Nigeria in '70-'90). Typology and sequence of general and specific policies in sectors that covers investment, trade, innovation and human resources are considered fundamental in linking FDI and development. While FDI usually are superior in terms of capital and technology, the spill over effect in local economy development is not automatic. Suitable politics for benefitting from FDI includes: a) building human resources, b) building technological/infrastructural capacities, c) maintaining a high absorbing capacity to seize the spill over effect. Countries have used general policies (improvement of an favorable climate toward investments) and specific policies (partnership programmes, tailor made development of human capital) to reach that point where FDI works for development. This doctoral research starts from Lee Chen dhe Ahn, 2001 thesis, theory which argues empirically the role that governmental policies play, thus the result of structural reforms in maximising the benefits from FDI. Indicators of an "active" lies from institutional quality, bureaucratic efficiency to corruptive practices. In any test of this econometric model, the role of good governance is evident and measurable. Our country's case- which is the focus of this research- does fit well with this theory, hence give us the chance to present political recommendations. We

note the fact that the structural reforms initiated from government is of major importance, say i.e. for the **know how** transfer and such thing can be proved by Lee Chen dhe Ahn 2001 model. Foreign Direct Investments are an important part of global capital flow. Even though the major part of literature in not consensual regarding financial globalization, FDI are believed to be a major channel through which the global finance helps local economy (Prasad et al, 2003). Different studies find evidence that support the argument in favor of the positive impacts of the spill over effect. FDI are also the most stable form of capital flow, making the country less dependant on the sudden slow-back of traditional capital flow (Kose et al, 2006). In this function, we create a unique data panel from '90 to 2012. The Eastern Europe region underwent massive structural reforms starting from '90. Our country's financial markets, trade barriers were liberalized and state companies were privatized massively. It is common belief that successful implementation of structural reforms are a positive signal for foreign investors because it implies lower investment risk. Thus the progress of structural reforms can be an impetus for FDI. In addition they suggest that structural reforms are more than just a signal. They generate real benefits for foreign investors, thus having an impact on the decision to invest in a certain country. Although the relevance, quite a few empirical research exist on the matter, which is the ratio between FDI and structural reforms. A reason for that is the difficulty in measuring "institutional clarity". Another reason is the misconception that the rational FDI- structural reforms is axiomatic. In other words usually is accepted that FDI are reforms: i.e. less barrier to foreign capital means more FDI and more privatizations translates to more investors interested to "enter" in market through purchase. This argument is somehow problematic once we figure that structural reforms comes in different forms and ways. This means that a certain reform in different countries has different results mainly cause of differences in the institutional component. In data construction, we try to isolate engagement for reform from result of reform. Regarding financial liberalization we differentiate in measuring indicators of financial development (result) and governmental policies (effort) in this context. Using these data, the main finding from the regression analysis is that: there exists a strong relation between FDI and structural reform. Among the structural reforms considered in this study, robust effect that impacts FDI can be traced from financial sector than from privatisation or trade liberalisation, thus suggesting that for foreign investors the financial system is most important, system which is able to allocate capital in effective manner. It must be stressed out that the findings of this research on the relative importance of structural reforms on FDI find support on the existing literature. For example, Alfaro et al (2004) analyses the links between FDI, financial development and economic growth and finds that well developed financial market are capable to exploit FDI more effectively. Similarly Prasad et al (2007) argues that absorbing capacity of a country measured with financial development is pre-condition to benefitting from FDI. Our result goes beyond that, suggesting that financial reform are more important than financial development itself also that financial reforms are more important than other structural reforms. Beyond financial reforms and

privatization, foreign investors are drawn to those countries which have macroeconomic stability, higher levels of economic development.

## CONCLUSIONS

The main conclusion that comes out of this paper is that economic benefits of FDI are real but do not happen automatically. To maximize the benefits from the foreign corporate presence a healthy business environment is needed, which encourages the domestic investments as well as foreign, promotes the innovation, improves the abilities and contributes to a corporate competitive climate. FDI benefits do not happen automatically and their magnitude changes due to the country politics and context. The factors that block the full FDI effects include among others education technological level, openness to trade, low competition, and weak regulatory framework. But even in the case when the host country does not have the proper economic development to benefit from the positive attributes of FDI, may benefit from FDI which have a limited access to international finance. The eventual economic effect of FDI in an economy with few financial resources varies mainly from developing politics that country authorities pursue, the structural content of the economy may help. While the service sector in many developing countries is underdeveloped and as such not able to attract FDI, the extraction industries may develop with FDI help.

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