

# A LEGAL FRAMEWORK FOR FOREIGN DIRECT INVESTMENT: A CASE OF AN EMERGING MARKET

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## Abstract

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There is unbridled competition among countries to attract foreign direct investments (Sethi et al., 2003). Developing countries are continuously revising their legal framework and policies to prevail in such a dynamic environment. The legal framework for foreign direct investment (FDI) in Kosovo since the establishment of temporary institutions until today has undergone constant changes and amendments to persuade foreign investors for investment purposes. The efforts to address issues raised by investors have played a pivotal role by shaping the legal environment in such ways in order to lure foreign investors. The main purpose of this study is to assess the legal framework in Kosovo by comparing the post-war and post-independence periods. This study adapts qualitative methodology and uses secondary data. The research concludes that although the legal changes were aimed at attracting foreign investors, this goal is still not being realized successfully. The findings of this research are very relevant because they can greatly contribute to other countries by learning the right lessons from Kosovo’s experience that can be used for other emerging markets.

**Keywords:** Foreign Investment, Law, International, Legislative

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## 1. INTRODUCTION

The decision of multinational corporations to start business activity in production, service, or trade in other countries, outside the country of origin, depends on basic factors such as a stable economic environment, better infrastructure, open economy, stable currency, political stability, and fiscal sustainability. After evaluating these factors these corporations look for other factors such as costs and benefits which are particularly related to the target projects. A single country cannot provide all these benefits to multinational corporations; however, the government can take measures to ensure basic standards such as political stability and better infrastructure. Usually, corporations are more interested in cost reduction rather than stability reasons. Host states create, approve, and promote

certain policies to encourage or discourage foreign direct investments (FDI) flows into their markets. Political ideology has been a determining factor in the past for the type and extent of these policies where, in general, states tend to avoid protective policies in the direction of the market and pragmatic nationalism.

To attract foreign investors, governments offer incentives of various forms including tax concessions, low-interest rates, subsidies, and grants (Sahiti et al., 2017). Thus, in addition to countries competing heavily with each other to benefit from the high volume of investment at the international level, strong competition is also taking place within regions within countries. Host countries on the other hand use a certain number of instruments to limit FDI flows by not allowing businesses with foreign capital to invest in their economic sectors that are

considered vital and vital in order not to undermine their stability and security. Mainly this happens in less developed countries as they believe that foreign businesses hinder the development of local businesses (Hill, 2011).

The conflict between host country governments and businesses with foreign capital usually arises due to the influence of investors on economic development, alleged violations of national sovereignty, control of key industries, exploitation of natural resources, the foreign exchange value of their currency, and the balance of payments (Eiteman et al., 2010). According to Wint and Williams (2002), the governments of different countries find it very difficult to distinguish between each other concerning the advantages of attracting foreign capital after using the available mechanisms. The convergence of promotional activities and government policies can differentiate the particular efforts of host countries in terms of their offer to foreign investors. In order to achieve the desired success, government reforms must be functional, non-selective, and serve the demands and needs of the market without discriminating against local businesses.

Unfortunately, the situation that a significant number of developing countries are going through today cannot provide the desired standards for businesses with foreign capital due to unfair competition, bureaucracy, level of corruption, and institutional fragility. With this security threat, not only the production and the social and economic well-being of the people in these countries are faced, meanwhile, the threat is also presented to foreign investors as the economies are continuously showing instability and thus, they are scaring the investors. According to Sethi et al. (2003), multinational corporations evaluate the firm's strategy factors along with the macroeconomic stability of a country. However, it can be said that many developing countries fulfill some factors of the strategy, but struggle to ensure macroeconomic sustainability which is the reason for the lack of investment. Investment laws provide a key condition for attracting foreign investors (Conahan et al., 2021) and for creating a positive business climate (Ziberi & Gashi, 2021).

The general overview of FDI in Kosovo shows that in recent years there has been great instability since fluctuations from year to year have been pronounced. This sign indicates the deterioration of the situation, which must be addressed to stabilize the trend and bring it back on track. Otherwise, continued volatility will bring even worse consequences, scaring even current investors. The banking system so far has been proven to be a very successful story in Kosovo due to the number of foreign banks operating and the consistent positive performance (Sahiti et al., 2023). Most of the FDI is oriented mainly in the sector of real estate, leasing and business activities, and financial services. According to the study conducted by Sahiti et al. (2020), the key determinants of FDI in Kosovo are interest rates, gross domestic product (GDP) growth, wages, and tax rates.

There are several studies on FDI in Kosovo, however, there is a research gap when it comes to the legal framework of FDI. Therefore, by conducting this research we aim to fill this gap. This research is

of paramount importance for investors, government officials, researchers, and students because it provides relevant information on the way that laws have been established concerning foreign investors in an ever-changing competitive environment. Findings that derive from this research serve to inform prospective investors when aiming to invest in Kosovo to make informed decisions and benefit in the best possible manner out of investment choices while fully abiding and complying with current laws in place.

The rest of this paper is structured as follows. Section 2 reviews relevant literature on the FDI legal framework. Section 3 provides the research methodology used and reasons why it is best suited given its nature and scope. Section 4 outlines the research results. Section 5 discusses the key changes that occurred in the FDI legal framework over time. Section 6 is the conclusion which shows the synthesis of key points on findings and insights of the research.

## 2. LITERATURE REVIEW

FDI has a positive impact on the development of host economies (Shkodra et al., 2021). It is also considered the countries received significant growth through foreign investors (Shkodra et al., 2019).

Political risk in the context of FDI can be defined as all the steps taken or actions and policies by a host country, individuals, or political groups and those of interest that may be illogical or arbitrary and which may hinder the development of free international trade and investment transactions. These political risks can manifest as a direct result of direct and indirect government actions. Risks include restriction of money transfers, restriction of money exchange, political violence, breaking of laws, and non-enforcement of contracts (Sachs et al., 2007). Therefore, it is a very big challenge and a heavy burden for managers to decide on investments in foreign markets since it is very difficult to predict the results of investments. Investments, once made, can be irreversible and as a result, uncertainty is very high in such situations (Fisch, 2011). The perception of political risk is believed to exist in developing countries (Sachs et al., 2007). On the contrary, developed countries do not have problems of this nature, their institutions are very stable and in no way harm the economic and financial activity of companies with foreign capital.

Political risk can be insurable and non-insurable (Sachs et al., 2007). As insurable political risks, in this case, the authors refer to transfer restrictions, breach of contracts, expropriation, and political violence. On the other hand, non-insurable political risks include legal, regulatory, bureaucracy, and non-governmental actions. Problems with currency convertibility can result in delays in transferring and exchanging money. Breach of contract refers to a violation by the government. Political violence indicates a war situation in the country, such as chaos in society, civil war, terrorism, or civil unrest. Legal risks, regulators, and bureaucracy are associated with the administrative process. These include corruption, manipulation of the law, conflict of authority at different levels,

delays in approvals, changes in laws, policies, and taxes due to changes in government, and obstacles during the arbitration process. Moreover, the risks of non-governmental action are those situations where the government has no control as trade union activists, religious extremism, ethnic problems, and foreign exchange risks.

There is a very limited amount of research in individual countries that shows a clear link that political risk impedes attracting FDI. The problem lies in the fact that it is very difficult to build a clear link between political risk and the damage it causes in FDI flows. Otherwise, if a clear link between the two could be shown, it would be very easy for policymakers in developing and less developed countries where political stability is a very big problem (Gobinda Goswami & Haide, 2014). Political risk in the case of the Asian financial crisis of 1997 was among the main internal factors that triggered it (Mina, 2015).

Political risk and corruption often do not deter foreign investors, they target similar environments due to the large investment returns from these markets as compensation for political risk and the high level of corruption (Van Wyk & Lal, 2010). In the study done by Quer et al. (2011), the results show that high political risk in foreign markets does not discourage Chinese corporations from investing. These findings are confirmed by Kang and Jian (2012) and Ramasamy et al. (2012), where it is emphasized that Chinese investors purposely target countries with high political risk, for the reason that they want to be among the first to expand economic activity in these countries. This is done to be one step ahead of corporations from developed countries and thus benefit financially.

From what has been noted above, it can be seen that multinational corporations from developed and developing countries take different actions concerning political risk in foreign markets where they intend to place their financial investments. While corporations from developed countries are more sensitive and prefer more stable foreign markets that offer higher security to their investments, corporations from developing countries have a different attitude toward political risk. Businesses from these countries often deliberately move to environments where high political risk prevails for reasons of greater opportunity and potential for greater financial performance.

The overview of FDI in Kosovo according to Table 1 presented below from 2007-2022 shows continuous fluctuations. The lowest level of FDI was in 2014, while the highest level was in 2022. It is interesting that during the election processes that were held in Kosovo and the ongoing political tensions, there was a decrease in the FDI flow. The origin of businesses that have contributed most to the Kosovo market through FDI is from Germany, Albania, Great Britain, Turkey, Slovenia, Austria, and Switzerland.

**Table 1.** FDI in Kosovo for 2007–2022

<i>Year</i>	<i>FDI inflows (million euro)</i>
2007	440.7
2008	369.9
2009	287.4
2010	368.5
2011	384.4
2012	229.1
2013	280.2
2014	151.2
2015	308.8
2016	220.0
2017	255.4
2018	272.1
2019	254.6
2020	345.7
2021	420.7
2022	732.0

Source: Central Bank of Kosovo (2024, January).

The most attractive sectors for foreign investors coming to Kosovo are real estate, financial activities, construction and supply of electricity, gas, steam and air conditioning, and the business sector. In the framework of this capital, a significant amount of these investments is from the Kosovo diaspora, who have immigrated to the countries of Western Europe, mainly during the period of the former Yugoslavia.

When it comes to the regulatory framework for FDI, it is tremendously important that a country builds up a transparent and appropriate regulatory (Bucaj, 2018). The legal system concerning FDI in Kosovo from 1999 and onward is well established and built in line with EU legislation, as such foreign corporations enjoy national treatment from the Kosovo government with well-defined laws to protect their way of doing business (Conahan et al., 2021). This is important given Kosovo's aim to join the EU, and current Kosovo's law addresses quite well unfair competition to avoid asymmetric market access (Grieger, 2019).

### 3. RESEARCH METHODOLOGY

The dimension of business research reflects the systematic gathering and analysis of data and materials to conduct a study on a phenomenon to establish new facts and reach conclusions because of the need to enhance knowledge of the relevant field of interest (Lomas, 2011). The methodology relates to the manner in which the research will be undertaken. Researchers need to understand its implications to make an informed choice (Saunders et al., 2009) given the overwhelming role it plays and its impact on the quality of the research outcome (Bryman & Bell, 2003). Thus, the paradigm of research methodology is crucial in today's fast-changing business environment for quality assurance purposes. It provides an in-depth understanding of the factors that link directly or indirectly to research and the precautions required to ensure its success.

A qualitative approach based on inductive theory will be adopted for this study given the actual nature and the scope of the research. This study aims to identify lessons that can be learned from Kosovo's success and experience in attracting FDI inflows by other developing economies. Qualitative research is best suited for this study because of the distinctive objective to provide a thorough understanding and interpretation of a phenomenon in the social world by learning the histories, experiences, and perspectives of participants included in the study (Snape & Spencer, 2003). However, critics argue that the qualitative approach is subjective and can be biased, unlike quantitative research, because of the strong emphasis on the descriptive narratives that ought to be interpreted by researchers. It also entails generalization problems and is subject to a lack of transparency (Silverman, 2011).

#### 4. RESULTS

By Resolution 1244 (1999) of the United Nations Security Council on June 10, 1999, the Special Representative of the Secretary-General of the United Nations, following the end of the conflict in Kosovo in June 1999, authorized the United Nations Interim Administration Mission in Kosovo (UNMIK) to establish Interim Institutions in Kosovo and to enact special regulations for the establishment and operation of these institutions. The adoption of regulations that sanctioned the regulation of emergency areas aimed at returning citizens to their homes and rebuilding the country; creating conditions for the normalization of the situation in the fields of security, local administration, education, health, and social policy characterized the year 1999. During those years there were no security circumstances, cohesive institutions, or legal infrastructure for domestic investments, let alone foreign investments.

However, UNMIK issued a considerable number of laws<sup>1</sup> during 2000 paving the way for local elections and the establishment allowing for the holding of local elections in October 2000 and the establishment of legal local government entities (Dalipi & Sahiti, 2017). Kosovo had begun to construct provisional executive and administrative organizations at the national level, as well as functioning courts at all levels. Local and national government bodies began to function normally in this spirit of state-building and the rule of law, and citizens began to have trust in the organization and running of normal life. The state had been decimated by the war in every way (Sahiti et al., 2020), therefore it was decided that, in addition to international assistance, it was vital to begin courting foreign investment. There were a lot of roadblocks to their fulfillment at first, including poor security in the country, amorphous local governance, and, in particular, a lack of legal infrastructure (Ahern et al., 2004).

#### 5. DISCUSSION

A foreign investment regulation was adopted in 2001 in order to reconstruct and strengthen Kosovo's economy and create a stable market economy to attract foreign investment (UNMIK, 2001).

In a legislative sense, this rule prepared the path for international investors to enter Kosovo. According to this regulation, foreign investment means a business organization that is at least 25% owned by a foreign investor. According to this act, the foreign investors included:

- (a) any natural person who is a resident or a national of a foreign State;
- (b) any legal person that:
  - (i) is established and registered under the law of a foreign State;
  - (ii) is established under the law in force in Kosovo with a legal address or principal place of business in a foreign country; or
  - (iii) is a foreign investment;
- (c) a foreign state or its administrative unit; and
- (d) a legal person established by a treaty or intergovernmental agreement (UNMIK, 2001, Article 2.1).

Because foreign investors were treated the same as domestic investors, the principles of this law were highly advanced. As a result, no foreign investment will pay a lower tax rate than a comparable local company organization (UNMIK, 2001, Article 3). Given the application of this regulation in an immediate post-war period, it decisively foresaw the emergencies that could occur in Kosovo. Foreign investments that suffer losses as a result of a war or other military conflict, revolution, emergency, civil conflict, civil unrest, or other similar circumstances will be afforded the same rights and legal protection as similar domestic business organizations, according to this regulation (UNMIK, 2001, Article 3, para. 1).

Despite these advantages and benefits for foreign investors, the regulation was limited, governed the issue of investments in general, and referenced previous Kosovo legislation. Due to a major lack of a competent administration, a still-fragile security situation, and an amorphous (shapeless) legal infrastructure, foreign investments in Kosovo were limited in the early years after the conflict. Foreign investors' lack of interest in investing in Kosovo has also been attributed to the country's political status under the United Nation's international administration. Since this regulation had been established before Kosovo's highest representative body, the Assembly of Kosovo, was elected, the Assembly of Kosovo repealed it in 2005 and passed Law No. 02/L-33 on Foreign Investments (Assembly of the Republic of Kosovo, 2006). The primary priority of this law was to encourage foreign investment in Kosovo by offering foreign investors basic and enforceable rights and guarantees that they and their investments will be protected and treated fairly, following international standards and practices (Assembly of the Republic of Kosovo, 2006, Article 1., para. 1.1).

The purpose of the adoption of this law was to help the economic development of Kosovo, especially in the field of the private sector which was at this time in the initial stage of development. This act aimed to enable Kosovo's full integration into the regional, European, and global economy by encouraging the transfer of capital, modern technology, financial and intellectual services knowledge, management skills, and information; to improve and expand Kosovo's capacity to receive

<sup>1</sup> UNMIK regulations that have legal force in Kosovo.

and send goods, services, and capital to foreign markets; and to increase Kosovo's predilection for foreign markets (Assembly of the Republic of Kosovo, 2006, Article 1, para. 1.2, a, b, c). While UNMIK Regulation 2001/3 on Foreign Investment in Kosovo left open the possibility of other legal acts in this field, i.e., other applicable laws, this law states that no law, regulation, or other normative act has a retroactive effect or can be applied retroactively to the detriment of a foreign investor or a foreign investor's investment (Assembly of the Republic of Kosovo, 2006, Article 6, para. 6.1).

This paragraph served as a further reminder that international investment in Kosovo is welcome. Beyond these incentives and protections, the legislation incorporates rules that ensure that foreign investors' capital would not be harmed by nationalization or expropriation of their property. Expropriation must not be done to discriminate. It shall be carried out by compensation methods that are quick, rational, and objective. Foreign investors are authorized to bring natural persons into Kosovo to participate in the conduct of business under this law, which provides investors with benefits through the issue of residence visas through objectively rapid procedures by the Kosovo Civil Registration Agency.

Unlike UNMIK Regulation 2001/3 on Foreign Investment in Kosovo, which did not establish any investment promotion bodies, this law established the Investment Promotion Agency, which functions as an executive agency within the Ministry of Trade and Industry, as well as the Advisory Board for the Promotion of Investments and the Foreign Investors Council. Whenever foreign investors face difficulties in carrying out their business, they are assured that their disputes will be resolved through arbitration, following the procedural procedures established by the foreign investor (Assembly of the Republic of Kosovo, 2006, Article 16, para. 16.2). As a result, the foreign investor had a fairly advanced position in Kosovo, allowing them to invest and expand their firm.

Following Kosovo's declaration of independence in 2008, the Assembly of the Republic of Kosovo began to review the laws in place at the time, either by changing them in specific sections or by making significant revisions. Law No. 04/L-220 on Foreign Investment was passed in 2014, replacing the 2005 law of the same name. This law underwent various amendments, in addition to changing the title of approval, i.e., from UNMIK-approved law to law approved by UNMIK. It is a minor detail, but it is not crucial. The general principles that sanction foreign investors' rights and obligations in Kosovo remained in force, as did the Agency for the Promotion of Foreign Investments, which is part of the Ministry of Trade and Industry, the Advisory Board for Investment Promotion, and the Foreign Investor Council, which is overseen by the Foreign Investor Council. The law, on the other hand, outlined some procedures governing the manner and form of foreign investment in Kosovo, with a focus on micro, small, and medium businesses.

According to the law, a microenterprise must have no more than nine employees, a small business must have 10–49 employees, and a medium business must have 50–249 people (Assembly of the Republic of Kosovo, 2014, Article 2, para. 1.21). Foreign investors receive rights and legal authorizations

based on these criteria. The law in question establishes more advanced criteria for immovable property expropriation, including concrete conditions for expropriation and actual compensation from immovable property.

The way of payment realization (bank circulation), currency conversion, and guaranteed transfers have been determined, taking into account the earnings and expenditures that a foreign investor may have in Kosovo through concrete legislative standards. A foreign investor has the right to convert any local currency that is legally used in the Republic of Kosovo into a freely convertible currency and to convert any convertible currency into local currency legally used in the Republic of Kosovo in relation to any payment, obligation, or profit related to a foreign investment organization or other investments in the Republic of Kosovo. A foreign investor also has the ability to freely move convertible currency both within and beyond the Republic of Kosovo (Assembly of the Republic of Kosovo, 2014, Article 9, para. 1).

To encourage foreign investment, this law, in addition to protecting businesses in normal conditions, also protects their assets during armed conflict and civil upheaval. If a foreign investor loses an asset or an investment in the Republic of Kosovo as a result of violence related to the political or economic situation, such as war, other armed conflicts, revolution, insurrection, demonstrations, protests, civil unrest, terrorist acts, or similar, the Republic of Kosovo will treat the foreign investor or foreign person in terms that are consistent with international law. In addition to security guarantees for foreign investors, which are implied due to the fragility of the state and state institutions, these investors have the option to stop their investment activity if they do not succeed in business, giving them the right to repatriate all physical and non-monetary assets to their home country.

## 6. CONCLUSION

The content of Kosovo's quest for FDI from a legal perspective is very rich and carries critical developments that occurred throughout the different stages. The developments of the FDI legal framework in Kosovo throughout the time have been examined and formulated in a very careful manner aiming to reap the benefits from the inflow of the foreign capital in Kosovo's national market. At the same time, the ultimate goal has been to protect some of the national industries that possibly could not withstand the competition derived from foreign corporations. Systematic ease of laws to allow foreign companies was endorsed given the fact that local firms were considered unable to compete given outdated technology, poor management skills, and expertise in comparison with their foreign counterparts.

In summary, the three foreign investment laws passed in Kosovo between 2001 and the present have made it possible for international investors to get legal assistance to expand their operations. The changes that occurred over time had the sole purpose of adapting to the needs and expectations of actual and prospective investors.

Each of these regulations is more developed and specific than the one before it. The absence of

foreign investment is not owing to a lack of statutory guarantees, which are relatively advanced; rather, it is due to a lack of public infrastructure and institutional instability as a result of high levels of corruption in state institutions, where these companies have repeatedly been harmed by the bureaucratic procedures of negligent state authorities.

Having newly established institutions and inexperienced officials, it can be said that Kosovo managed a way to succeed in this matter by continuously addressing investors' needs and concerns.

To conclude, it can be said that the issue of competition on FDI legal frameworks will dominate the struggle of developing countries to compete in global markets. Those countries that are capable of

devising laws that are consistent with the goals and objectives of foreign investors and that allow them to extract maximum capitalization from their presence are likely to benefit most and prevail in this respect. Otherwise, unfriendly FDI laws that limit the activities of foreign corporations and which are based on protective measures are bound to lead to failure.

The lack of previous research studies on the topic is a limitation for this study because it has not been explored previously. Future research could investigate this issue by delivering a questionnaire to the current foreign investors to assess on how the FDI legal framework is impacting their business activities.

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