

## THE ROLE OF LOCAL GOVERNMENT TO INCREASE FLOWS OF FOREIGN DIRECT INVESTMENT IN SHKODRA REGION

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### Abstract

The successful FDI performance of CEE countries during their preparation for the EU accession in the last years shows that FDI inflows can have a very positive impact on the economic development of a country. Although FDI in Albania have increased over the last few years, it still remains among the lowest in the region of Western Balkans with a large part of FDI inflows coming from large state enterprises privatizations. In order to increase FDI inflows, the Government of Albania has intensified its efforts to implement a number of fiscal and legislative reforms to improve the business climate in Albania. In order to attract FDI, the Albanian Government has developed a range of incentives for foreign investors in Albania, such as the "One stop shop for granting licenses", tourism and energy sector incentives as the most interesting sectors for investment actually in Albania. The signing of the Stabilization and Association Agreement with the EU in June 2006, Albania's transition into a NATO country and the prospective European Union (EU) membership are considered as important factors contributing to the increased FDI inflows even during the financial crisis period. During the last two years, Albania experienced an increase in foreign investors' interest in a wide range of sectors, with energy generation, telecommunication, cement production, mining, oil and industrial parks heading the list. However, the major obstacle factors for FDI inflows seem to remain the same: pervasive corruption, weak law enforcement, poor rule of law, lack of developed infrastructure, lack of a reliable energy supply and insufficiently defined property rights. This paper analyses FDI inflows in the region of Shkodra focusing on the actual situation of FDI inflows and the opportunities that this region offers to attract new foreign investments as a way to increase employment, bring new technologies and effect the further economic development of this region. The paper is going to analyze the role of local government incentives in attracting FDI in Shkodra.

**Keywords:** FDI, incentives, EU integration, promotion, Shkodra region, local government.

### Introduction

Foreign direct investments (FDI) play an important role in the economic development of a country. Evaluating the development of specific sectors in transitional countries is important in understanding the effects of FDI.

According to UNCTAD (1999), FDI can complement local development efforts by: increasing financial resources for development, boosting export competitiveness, generating employment and strengthening the skills base, protecting the environment and social responsibility, and enhancing technological capabilities (transfer, diffusion and generation of technology).

The relation between FDI and the level of economic development is not just one direction. FDI inflows affect economic development, but at the same time, levels of economic development have a positive influence on attracting FDI. Thus, the attraction of foreign investments has a great importance for the economic growth and the future integration of the country. For these reasons, it is very important to create the most favorable environment to draw foreign investments in the country. Although low compared with total foreign investment in Albania, FDI-s in Shkodra have experienced a significant increase especially during the last 5 years. Shkodra has historically been one of the main Albanian cities. In 1870 it had about 50 thousand inhabitants. Shkodra took a considerable development in the nineteenth century. It became an important commercial node for the Balkans, with a center containing around 3,500 stores in the area known actually as "The old bazaar". It was the last Albanian town to fall under the Ottoman regime in 1479, and the city that mostly opposed communism in 1944.

### 1. FDI attraction literature

The investment attraction literature can be divided into two parts, the first one is the *Investment Climate* literature propelled by the World Bank's 'Investment Climate Surveys' and crystallized in the recent 2005 World Development Report entitled 'A Better Investment Climate for Everyone'. The second can be called the *Investment Promotion* literature, which is primarily addressed in Multilateral Investment Guarantee Agency (MIGA) and United National Conference on Trade and Development (UNCTAD)-led forums.

#### 1.1 Investment climate literature

According to the 2005 World Development Report, a good investment climate will provide opportunities and incentives for private firms – from farmers and small entrepreneurs to local manufacturing companies and multinational enterprises – to invest productively, generate jobs and expand. For most purposes, the investment climate refers to the level of costs, risks, and barriers that may affect an investor's perception of returns to be gained from an investment (IBRD 2005).

Factors that would affect the level of perceived costs, risks, and barriers may be categorized into three components. The first would be *inputs* – which entail infrastructure and services (both physical and financial) as well as labor – that are vital to a firm's productivity. Cross-country analysis appears to corroborate that the attractiveness of a country towards FDI correlates with the availability of physical infrastructure (Kumar 2001), and that human capital formation and skills development can also attract FDI (Miyamoto 2003).

The second component of the investment climate is the *regulatory* environment – which includes regulation of entry and exit, the labor market, financing and taxation, as well as public interests such as the environment, health and safety. Javorcik, Beata Smarzynska and Mariana Spatareanu (2003) for example discuss the effects of labor market regulation; Morrisset and Pirnia (2000) examine the effect that regulatory fiscal instruments such as taxes may have on FDI with a cross-country analysis.

The third component is the set of *macro* or country-level issues concerning economic and political stability and what Gliberman and Shapiro (2002) refer to as ‘governance infrastructure’. ‘Positive’ governance infrastructure includes an effective, impartial and transparent legal system that protects property and individual rights; public institutions that are stable, credible and honest; and government policies that favor free and open markets. (Kaufmann, Kraay, and Zoido-Lobaton 1999; Keefer and Knack 1995)

## 1.2 The Investment Promotion Literature

The second body of work relevant to FDI attraction policies takes the approach that the ‘enabling framework’ (Kumar 2003) of an improved investment climate is not enough to attract FDI in today’s competitive world. The amount of world FDI flow is increasing (UNCTAD 2004) due to pressure for companies to seek opportunities overseas in order to increase profits; and so is recipient countries’ competition for their share of this growing pie. In both the developed and the developing world, this competition for FDI manifests in the form of investment promotion activities. ‘Governments of developing countries need to go beyond offering a “passive open door” regime for FDI’ (Kumar 2003). Competition for a piece of the pie has driven governments to more proactive strategies, that is, marketing their area through investment promotion agencies, or ‘IPAs’.

In 1964, at the first United Nations Conference on Trade and Development, the issue of promotion of foreign direct investment was addressed. The Conference recommended that developing countries ‘set up investment bureau and investment advisory services and ... determine and publicize areas of investment, manner of investment and investment policy.’ The Conference also recommended countries ‘to establish information centers ... to supply all the necessary information about investment conditions, regulations and opportunities.’ It was not until the 1980s, when more attention was being paid to the role of FDI in economic development, however, that most countries had set up IPA (Fredriksson 2003).

## 2. The role of Albanian Government incentives on attracting FDI

FDI incentives have been defined as “any measurable advantages accorded to specific enterprises or categories of enterprises by (or at the direction of) a Government, in order to encourage them to behave in a certain manner” and include “measures...designed either to increase the rate of return of a particular FDI undertaking, or to reduce (or redistribute) its costs or risks”. They are seen as distinct from “broader nondiscriminatory policies” such as “the

general...fiscal regime for business operations” (UNCTAD, 2000,).

The term “FDI incentives” covers fiscal and financial benefits. Fiscal incentives include full or partial holidays from tax; reductions in the standard rate of tax; tax reductions conditional on reinvestment of profits; investment allowances and investment tax credits; accelerated depreciation of assets; preferential treatment of profit on exports; tax deductions based on specific types of expenditure (e.g. R&D); and exemptions from import duties on capital goods or other inputs (list adapted Financial incentives include: cash grants related to the value of assets invested or numbers employed or training costs; provision of subsidized facilities such as factories or sites; provision of infrastructure related to new facilities, such as roads and links to utilities; and direct subsidies (UNCTAD, 2000) .

### 2.1 Fiscal and financial policy incentives

There is a growing body of work that examines the effectiveness of tax and incentive policies in attracting FDI (Cass, 2007). The development of the tax system is very important for attracting FDI inflows in transition economies. When transition began, taxes on companies represented a higher share of government revenue and of GDP than in the high income OECD countries (Mitra and Stern, 2002), linked to a tradition of heavy taxation of enterprises. In the early years of transition, countries faced erosion of tax revenues and needed to create institutions for raising revenue in a market economy. Incentives could arguably insulate potential investors both from the initial high tax rates and from the uncertainties associated with tax reform. The Government of Albania has played an important role on improving the business climate in Albania. In order to increase FDI, the GOA has developed a set of fiscal and legislative policies:

- Reduction of the fiscal burden of social security contributions payable by employers from 20 percent to 15 percent ( on May 2009 ).
- Introduction of a flat tax of 10% on personal income tax.
- Tax exemption of dividends designated for investments.
- Reduction of corporate tax from 20 to 10 percent ( on January 2008).
- Importers of machinery and equipment are exempt from VAT if the machinery and equipment are used solely as part of their taxable economic activity.

### 2.2 Investment Promotion Agencies

Albinvest is the Albanian Promotion Agency for foreign investors. The Albanian Government has assigned Albinvest three strategic goals:

- Assisting and accelerating the inflow of foreign investment into the Albanian economy
- Improving the competitiveness of Albanian exporters
- Providing professional services to assist the growth of Albanian SMEs.

According to “Investment Reform Index” 2010, Albania needs to focus on improving services to investors in both

pre and post establishment phase. Albania should explore the possibility of Albinvest having authority to approve some permits and licenses. Also a more sophisticated approach to client relationship management (CRM) is needed.

Many activities in Albania required cumbersome licensing procedures and permits. According to The US State Department's 2009 Investment Climate Statement, the GOA approved the Action Plan for Regulatory Reform, in 2007, which provided for a full review of Albania's entire legal licensing system to harmonize the licensing legislation to EU standards and reduce administrative barriers for businesses operating in Albania. As a result, many licenses were removed while a broad simplification of licensing procedures has been completed in many sectors including, mining, hydrocarbons, public works, health, agriculture and the environment. Part of GOA's incentive for foreign investors is "**One stop shop for granting licenses**". The Albanian Government's has established on May 2009 the "One Stop Shop" for issuing licenses and permits, National Licensing Center (NLC). This will lead to the simplification of licensing procedures. From now on the time and effort required to obtain a license is significantly lower. The procedures for getting a license are the same for national and foreign companies.

### **2.3 GOA efforts for the Albanian Integration processes**

Foreign direct investments (FDI) interest in Albania is increased during the last years. Albania's transition into a NATO country and the prospective European Union (EU) membership are considered as two important factors contributing to the increased FDI inflows even during the financial crisis period.

Albania joined NATO (North Atlantic Treaty Organization) on April 1, 2009. This important membership of Albania has improved its image to foreign investors, considering the fact that Albania is still seen as a high political risky country as a result of the ethnic conflicts and wars that involved the region of Balkan after the nineties.

The Western Balkans process of integration has two important aspects: on one side the intra-regional economic cooperation within this region after the long period of disintegration before the nineties and a lot of ethnic conflicts after the nineties will improve the economic relations and create a common market in this region, on the other side all the countries of this region aspire to access to the EU. The region does not present itself homogeneously regarding European integration.

The process of accession of Albania to the EU started in January 2003. *The Stabilization and Association Agreements (SAAs)* are the main form of contractual relationship between the EU and each Western Balkan country. Albania has signed the SAA with EU on 12.6.2006. Albania formally applied for EU membership 28 April 2009. On November 16, 2009, the foreign ministers of the EU approved the starting process of Albania to get the candidate status for EU. Albania's admission to the EU depends on the countries future economic and political stability.

Albania's integration in the multilateral trading system has been steadily increasing. The entry into force of a free trade agreement with Turkey in 2008 and with the Stabilization and Association Agreement with EU in 2009, are very important steps in this aspect.

### **3. FDI-s in the region of Shkodra**

#### **3.1 General situation of FDI-s in Shkodra**

Economic development and foreign investment in Shkodra continue to be lower and it comes mainly from the continued gaps of the judicial system, customs, taxes and other issues like corruption, high informality, lack of infrastructure and problems of ownership.

Foreign investment firms in Shkodra are treated equally according the law as well as domestic ones and are guaranteed against expropriation and nationalization. All sectors of the economy in Shkodra are open to foreign direct investment. In Shkodra, according to information received by the Municipality of Shkodra (Department of Foreign Development Affairs) and the Tax Office have the following information about foreign investments for 2010:

- The number of foreign firms and joint capital is 52, from which 18 are foreign firms and 34 joint capital

Most foreign investment in Shkodra are made in the manufacturing sector (55%). Dominant investments in this sector belong to the textile industry (38%). About 72% of foreign investments in industry are joint ventures or foreign material to work with the requester, where about 80% of them belong to the clothing sector. There is a domination of foreign enterprises and joint-ventures from Italy but also German investments (ALB-TIEFBAU), Montenegrin, Bulgarian (ALFA / SH), etc. are present in Shkodra actually. There is a positive growth of foreign entities and joint activities that have extended in Shkodra during these years. So, from 2004 when there were only 21 entities, now we see an increase of 150% of them. Most of the subjects (65%) are joint capital.

The main reasons to invest in Shkodra are "lower labor cost" and geographic location. These foreign firms have a positive impact in reducing unemployment and bringing new various technologies in Shkodra, which in turn helped in the creation of many new local businesses.

Shkodra in relation to the total number of foreign enterprises and joint that realize economic activity in Albania, occupies approximately 5% of total foreign investment. The current level of FDI in Shkodra compared to the total is too low considering the potential of Shkodra in terms of attracting foreign investors.

#### **3.2 Opportunities for investments in Shkodra**

Possibilities for Shkodra to return its primeval name are not fewer. Opportunities exist; everything depends on strategies and desires, but also on providing funds to exploit them. Natural and human potentials of Shkodra together its geographical position to be connected with other neighboring countries, are some of the reasons why foreign investors and domestic ones need to invest in Shkodra.

Strategic geographical position is a priority for Shkodra, making this region to be a bridge crossing for local and

foreign businesses with close neighboring countries such as Montenegro, Kosovo, Serbia and Italy.

Natural resources are another advantage for this region. In the area of Shkodra there are a lot of very good quality mineral resources, which are fully utilized. On the other hand, an advantage for investors is the low cost of labor, but also a specialized work force.

### **3.3 Foreign investments that are oriented in human sources in Shkodra**

#### **- Sector of clothing and shoe-leather production**

As we noted above, most foreign investment in Shkodra are in the manufacturing sector (55%). Investments dominating this sector belong to the textile industry and shoe-leather. About 72% of foreign investment in this industry sector work with the material ordered, where about 80% of them belong to the clothing sector. About 68% of employees in foreign enterprises and joint-ventures belong to textile industry and leather - shoe. These industry sectors have been a major source of employment for Shkodra since years '90.

Nevertheless, positive role in employment of foreign enterprises in these sectors of the economy of Shkodra, it must be mention that most of employees in these sectors have 8-year education and secondary education, and this creates an idea that human potential for Shkodra can be used mainly in sewing.

While Shkodra has human potentials that can be used more effectively in other sectors of the economy. What is missing this force labor in Shkodra is the lack of promotion, mainly by local governments and the University of Shkodra (as the educational metropolis of northern Albania).

#### **- Services to business**

In this aspect Shkodra as metropolis of northern Albania, presents great opportunities to attract foreign investment. This is due to several competitive advantages that Shkodra region has such as: a qualified workforce (University of Shkodra, professional schools and professional training centers), foreign languages (most of the young people in Shkodra speak Italian and English) and with an average cost as a fifth of European countries but lower than other more developed regions in Albania such as Tirana or Durrës, the opportunity to provide office and environments with high standards thanks to the boom of new construction in Shkodra during this period, developing telecommunication network etc.

#### **- Banking System in Shkodra**

First Bank in Albania began its life just in Shkodra in 1863 as a subsidiary of Bank Ottoman of Turkish Empire Real bank. This bank was under the control of Anglo- French capital.

In the early 90s after the radical changes that occurred, Savings Bank established its branch in December 1992, while National Bank opened its branch in Shkodra in January of 1993.

Early 2000 will bring a substantial increase in bank branches in Shkodra. Actually in the city of Shkodra operate 13 second-tier banks, which contribute positively to

employment and development of the city. Expansion of the banking sector in recent years in Shkodra (through the opening of bank branches), has impacted positively on the economy, lending and simplify the many financial services to domestic and foreign businesses currently operating in Shkodra, and in expanding of the labor market in this region.

Development of the banking market in Shkodra was associated with an increase of employees at these financial institutions, where a significant number of them were graduated from the Economic Faculty of Shkodra. It should be emphasized that until three or four years before there was a tendency of employing the majority of graduates of the Economic Faculty outside the city of Shkodra because the number of banks was small and consequently the demand for employment in banks was low. Currently in the banking market of Shkodra above 60% of employees are graduated at Economic Faculty in Shkodra University.

### **3.3 Measures taken to attract FDI - in the region of Shkodra**

Although low compared with total foreign investment in Albania, FDI in Shkodra have experienced a significant increase especially during the last 4 years. But which are some of the reasons for this increase? Some reasons are national and others are entirely local:

Among national reasons the most important that we can mention is the signing of the SAA, which opened the way for Albania towards full integration into the EU, and as mentioned at the beginning of this paper, all studies related to EU integration and its role in FDI flows to countries involved in this integration, show a strong positive relationship between these two elements. On the other hand, the end of the war in Kosovo and NATO membership have significantly reduced political risk for Albania, positively affecting foreign investors who until some years ago considered Albania a dangerous area for investment. Also the government has taken several measures to increase the attractiveness of Albania in the eyes of foreign investors and here we will mention the initiative "Albania 1 euro".

But there are also some local factors that have impacted positively in terms of FDI-s. So we can mention the investments made by the Municipality of Shkodra in the improvement of infrastructure (light and water supply, reconstruction of many roads, etc.). These investments are made in the implementation of the strategy for business development in Shkodra where a set of objectives are related with attracting foreign investors. Also it is important to mention the work of some NGOs as TEULEDA which have organized several activities abroad in some regions of Italy to promote Shkodra and its potentials for foreign investors. A positive rating for Shkodra comes from a recent report by the World Bank which, in a study about the facilities of doing business in SEE economies ranks it (Shkodra) in third place in this region of Europe in terms of doing business facilities (first in terms of starting a business). Factors that have contributed to this positive assessment are that the days of opening a business in Shkodra are only 7 and the procedures

required for its opening are only 6 (World Bank Report, 2008).

## RECOMMENDATIONS

- Shkodra has many human resources. Shkodra has a population of young middle-aged, educated and willing to work people, but the efforts of government and local government should focus on the efficient promotion of these resources. Development of labor market fairs by local authorities, in cooperation with the University of Shkodra, to present human capacities in the region of Shkodra, we think it might be a good opportunity to promote them.
- Although Shkodra has a favorable geographic position, which favors the development of mountain, sea and lake tourism, FDI in this field does not exist. For this reason, we recommend a greater promotion of this sector abroad, through various forms of marketing. The local government may appoint a special fund to achieve this promotion abroad.
- Local authorities in the Shkodra should encourage and finance such initiatives as that of the NGO, "TEULEDA" for promotion of Shkodra in different regions of Italy.
- Given the low level of FDI in the region of Shkodra, also we recommend the creation of a regional agency for FDI,

which should provide information and recommendations on foreign investment in priority sectors of the economy of the region of Shkodra. Also, this agency can stay constantly in touch with investors currently operating in the region of Shkodra, to identify problems they encountered and offer possible solutions.

- Local authorities of Shkodra should strength links with immigrants, mainly in the region of Shkodra, living and working abroad, in order that they be encouraged to come and invest in the Shkodra.
- Revival in the Shkodra of some manufacturing activities successful until the 90s through internal investments, we think it can provide very positive effects in the future to attract foreign capital.
- Local government, in cooperation with the local business community and foreign investors as well as academic staff of the University of Shkodra, can draw a complete and specific strategy to encourage foreign investments as an important factor in the economic growth.
- Creation of an industrial park with infrastructure and services necessary to reduce investment costs in Shkodra region, contributing to increased foreign investment inflows.

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